

Indian bankruptcy reform

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Outline

- ▶ What is wrong with the present framework?
- ▶ Features of a sound approach
- ▶ BLRC
- ▶ The BLRC proposal
- ▶ Cautious optimism

Part I

What is wrong with the present
framework?

What happens when a firm fails?

- ▶ Three legs of the stool:

Enforce collateral

SARFAESI

Collective action

Absent

Liquidation

Failed

- ▶ There are some restricted, collective action, out of court mechanisms like CDR. For Banks only.
- ▶ Divine right of promoters.
- ▶ Capital and labour get interminably stuck.
- ▶ Bottom line: recovery rate estimated at 20%.

Consequences

- ▶ NPA problems of banks?
- ▶ The real issues run deeper.

Consequences

- ▶ NPA problems of banks?
- ▶ The real issues run deeper.
- ▶ Some debtors were empowered under SICA 1985.
- ▶ Some secured creditors were empowered under RDDDBFI and SARFAESI: Other lenders (bond market) and unsecured creditors shy away.
- ▶ Equity market has learned financing based on assessing future prospects of firms: debt market has not.
- ▶ Pressure to pierce through limited liability and pin responsibility on promoters: this can hamper risk-taking. Theft by promoters is a crime; business failure is not.
- ▶ Lack of access to debt capital for projects with intangible assets.

Part II

Features of a sound approach

0. A systemic reform

- ▶ Multiplicity of badly working frameworks has created chaos.
- ▶ All existing frameworks must be repealed to give way to a single coherent and simple approach.
- ▶ Aim for an 'Indian Bankruptcy Code' which replaces all existing law on this subject.

1. The contract between equity and debt

- ▶ Equityholders should not always have control of the firm
- ▶ When they default, control should transfer to the debt holders
- ▶ The Indian notion of the 'divine right of promoters' must end.

2. Protect organisational capital, in a sensible way

- ▶ Some firms contain organisational capital. Rushing too quickly into liquidation can destroy value.
- ▶ The decision of going concern vs. liquidation is not the job of any part of the State.
- ▶ Commercial thinking alone.

3. Calm period

- ▶ Creditors banging on the door, grabbing assets, can kill the firm.
- ▶ Need a 'calm period' where the firm is immune to the claims of creditors, while the future of the firm is figured out.
- ▶ In the calm period, the assets of the firm are monitored and the firm is managed by a regulated professional, the Insolvency Professional.

4. Liquidation

- ▶ If the firm can't be saved as a going concern, it goes into liquidation.
- ▶ Clear waterfall of priorities which determines who gets the cash.
- ▶ Committee engaged in enormous cogitation and debate, and review of international experience, before choosing the proposed waterfall.

5. Need for speed

- ▶ The bankruptcy process must work swiftly – every day of delay imposes costs upon society.
- ▶ Use IT to eliminate delays and disputes about facts.

6. The role of the judiciary

- ▶ Ensure that the processes defined in the law are being followed
- ▶ Not get into business decisions
- ▶ Work swiftly – every day of delay imposes massive costs upon society.

Part III

BLRC

Bankruptcy Law Reforms Committee

- ▶ After FSLRC, a more ambitious approach to drafting of law.
- ▶ On 22 August 2014, DEA setup this committee, chaired by Dr. T. K. Vishwanathan.
- ▶ On 4 November 2015, the Committee released a Volume 1 (economic thinking) and Volume 2 (draft law).

Part IV

The BLRC proposal

Firm default

- ▶ When a firm defaults, it goes into an Insolvency Resolution Process, with oversight by an Insolvency Professional
- ▶ A Creditors Committee receives proposals for revival, buyout, etc.
- ▶ If a proposal gets 75% votes in the Creditors Committee, this goes through.
- ▶ All this has to happen in 180 days.
- ▶ Else, the firm goes into liquidation.
- ▶ Key insight: In general, liquidation is value-destroying. The pressure of having only 180 days for the IRP focuses all parties to finish the negotiations and come out with an answer.

Individual default

- ▶ When a low-income, low-asset, low-debt individual defaults, he qualifies for a “fresh start”
- ▶ When a individual not eligible for a fresh start defaults, he goes into an Insolvency Resolution Process, with oversight by an Insolvency Professional
- ▶ A Creditors Committee decides on the reorganisation plan, in consultation with the debtor
- ▶ If the reorganisation plan fails, then the creditors may take the individual into a “bankruptcy process” where his assets are liquidated.

Enabling infrastructure

- ▶ IRP for firms, IRP for individuals – looks great.
- ▶ How to make it work? Four pillars of infrastructure.
 1. A private competitive industry of Information Utilities
 2. A private competitive industry of Insolvency Professionals
 3. Efficient and well functioning tribunals
 4. A regulator.

Information utilities

- ▶ Facts about lending, pledges, etc.
- ▶ A private competitive industry of 'information utilities' that will store such filings and make them available.
- ▶ Market failure: market power
- ▶ When a firm defaults, the information utility who has relevant records can gouge customers
- ▶ A careful design to address this market failure.

Insolvency professionals

- ▶ Professionals as part of an association.
- ▶ ICAI, ICSI, etc. haven't worked well.
- ▶ The exchange architecture has worked better: Regulator – exchange – member.
- ▶ Multiple competing private IP Agencies
- ▶ Each with legislative, executive and judicial functions
- ▶ Oversight of a regulator.

Well functioning tribunals

- ▶ NCLT is the proposed forum for corporate bankruptcy.
- ▶ DRT is the proposed forum for individual bankruptcy.

A well functioning Regulator

- ▶ The work :
 1. Legislative function on procedural details of the insolvency process
 2. Statistical system functions
 3. Legislative, executive and quasi-judicial functions on IP Agencies and IPs
 4. Legislative, executive and quasi-judicial functions on IUs.

Part V

Cautious optimism

BLRC is an important first step

- ▶ Designed from first principles, and with ground realities in mind.
- ▶ A single integrated law which replaces all existing provisions
- ▶ Not just a report, also a draft law
- ▶ Ambition and capability which was not found in previous decades.
- ▶ Now there are six hoops to jump.

1. Perfecting the law

- ▶ Litigation will focus on every chink in the law
- ▶ Very careful review of the law in order to achieve extreme precision of drafting
- ▶ Learn from our long history of the ambiguity associated with old style Indian drafting of law.
- ▶ Full machinery for the pillars of infrastructure are explicitly provided for in the law.

2. Parliamentary approval

- ▶ When will it be tabled?
- ▶ Standing committee process?

3. Institution building for the tribunal

- ▶ At DEA, the Task Force on FSAT has done a lot of work on the business process engineering of a tribunal.
- ▶ Envisages 'Financial Sector Tribunal Services' (FSTS) which will perform managed-operations for courts.
- ▶ Can this approach be brought into building NCLT?
- ▶ What about the adjudication infrastructure for individual insolvencies?

4. Institution building for the Regulator

- ▶ At present, the working of regulators in India has many problems
- ▶ How to build a high performance organisation?
- ▶ How to avoid the problems that are visible with existing regulators?
- ▶ 85 sections from version 1.1 of the Indian Financial Code on how to setup a regulator properly: board, transparency, rule of law, legislative, executive, quasi-judicial, penalties.
- ▶ At DEA, a 'Task Force' process was begun to construct the institutional infrastructure for the draft Indian Financial Code.
- ▶ A similar effort is required here.

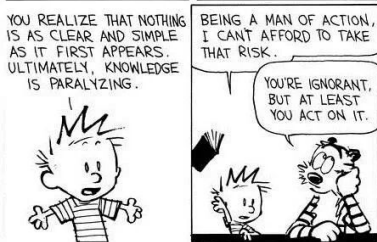
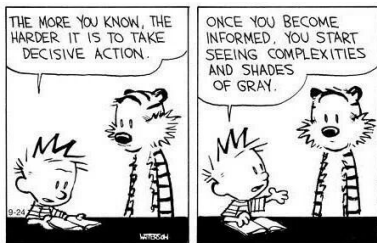
5. Insolvency professionals

- ▶ On day 1 who will the IPs be?
- ▶ Who will start IP Agencies?
- ▶ What is the regulatory framework they will operate under?
- ▶ How do we get to the steady state equilibrium, with multiple IP agencies and a large pool of capable IPs?

6. Information utilities

- ▶ On day 1, all the data is in physical paper
- ▶ It's a bit like stock depositories – when they started up, transactions on exchanges were settled in physicals
- ▶ We have to start a process whereby there are incentives and regulatory compulsion in favour of electronic data
- ▶ Over a few years the entire system should shift over to electronic information.
- ▶ Who will start the information utilities?
- ▶ What is the regulatory framework they will operate under?

Conclusion



- ▶ Individual and firm insolvency is a critical building block of mature market economies.
- ▶ BLRC is a beginning.
- ▶ We should be careful to pursue the desired outcome and not tokenism.
- ▶ Tabling or enacting a new law, or getting a higher score in the Doing Business rankings: these are not the end-goal.
- ▶ This is a complex project, requires a commensurate project team.

Thank you.