

# India's corporate bankruptcy reform

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# Outline

- ▶ Elements of a sound insolvency system
  - ▶ Layout of any bankruptcy law and what we see in India
  - ▶ General progression of bankruptcy laws
  - ▶ Economics of a sound insolvency system
- ▶ The present framework in India and related problems
  - ▶ Evolution of the bankruptcy framework
  - ▶ Legal and Economic outcomes
  - ▶ Reforms in Indian bankruptcy
  - ▶ Errors in reform policy
- ▶ The BLRC approach
  - ▶ Principles of design
  - ▶ Design of the Insolvency and Bankruptcy Code (IBC)
  - ▶ Institutions under IBC
  - ▶ How is IBC different?
- ▶ Way forward

# Some definitions

- ▶ **Default:** when a borrower fails to repay.
- ▶ **Insolvency:** the state where a borrower is generally acknowledged to be unable to repay.
- ▶ **Rehabilitation / Reorganisation / Restructuring / Revival:** financial or operational re-engineering that can be done that will allow a borrower to eventually repay.  
Here, the enterprise continues to exist.
- ▶ **Bankruptcy:** when it is established that the borrower can never repay.  
Here, the enterprise has to be shut down.
- ▶ **Liquidation:** the process by which the bankrupt enterprise is shut down.

# Part I: Elements of a sound insolvency system

# The layout of any bankruptcy law

- ▶ Purpose of law: incentivise socially optimal behaviour on the part of economic agents at all times.
- ▶ Economic agents in a bankruptcy process : creditors / lenders and debtors / borrowers.
- ▶ What is optimal in insolvency and bankruptcy?  
Minimise the loss to all parties concerned.

# Underlying principles of any bankruptcy law

- ▶ What needs to be respected :
  - ▶ Failure of business is a normal thing.
  - ▶ In failure, limited liability should be respected.
  - ▶ Speed of resolution is important so that capital and labour can be put back to work quickly.
  - ▶ Insolvency and bankruptcy resolution should be an economic decision; not a judicial decision.

# What we see in India

- ▶ Weak capacity to separate theft from business and genuine business failure.
- ▶ Theft by promoters is a crime; business failure is not.
- ▶ Catchphrase “poor companies, but no poor promoters” gaining popularity to apply to all business failure: divine right of promoters.
- ▶ No collective action procedure.
- ▶ Capital and labour get interminably stuck.
- ▶ Lack of access to debt capital for projects with intangible capital.

# General progression of a country's bankruptcy laws

- ▶ Inherent tension between rights of the creditor vs. the rights of the debtor.
- ▶ The earliest laws protected the rights of the creditors. Default → “Debtor’s prison”.
- ▶ But this did not necessarily lead to a rapid resolution of insolvency. It created a disincentive for enterprise and risk taking.



# General progression of a country's bankruptcy laws

- ▶ A combination of limited liability and strong insolvency process allows firms to undertake risky ventures while protecting creditors' rights. The bargain:
  1. Firms accept disclosure
  2. They agree to work with lenders in insolvency
  3. In return firms get limited liability
- ▶ The rise of limited liability needs to be accompanied by (a) strong recovery laws, and (b) strong insolvency law.

# Elements of a sound insolvency system

# The economics of insolvency reform

- ▶ Breadth and depth of credit markets:  
Where lenders can enforce repayment, there is: (1) higher credit access, (2) at lower price, (3) with longer maturity, (4) lower collateral requirement , and (5) from a greater number and variety of lenders.
- ▶ Commercial confidence and predictability.  
When insolvency systems function, lenders can price risk more accurately and manage it more effectively.
- ▶ Balance in commercial relations.  
More responsible behaviour by debtors and creditors. Improved corporate governance.
- ▶ Efficient allocation of resources.  
The possibility of exit promotes entrepreneurship. Effective exit provides a safety valve for corporate distress.

## **Part II: The India situation - What is wrong with the present framework?**

# How the bankruptcy framework evolved

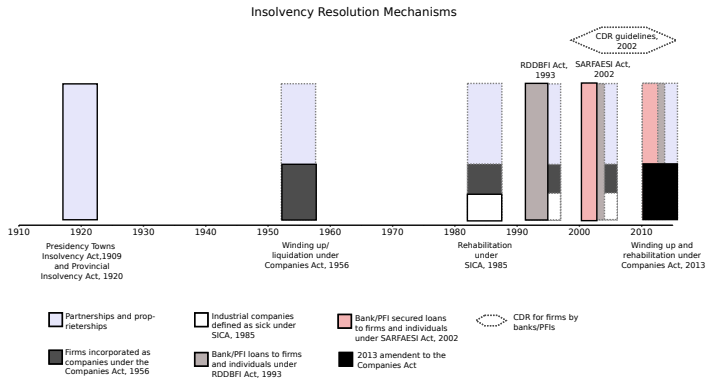


Figure: Prepared by Anjali Sharma, FRG

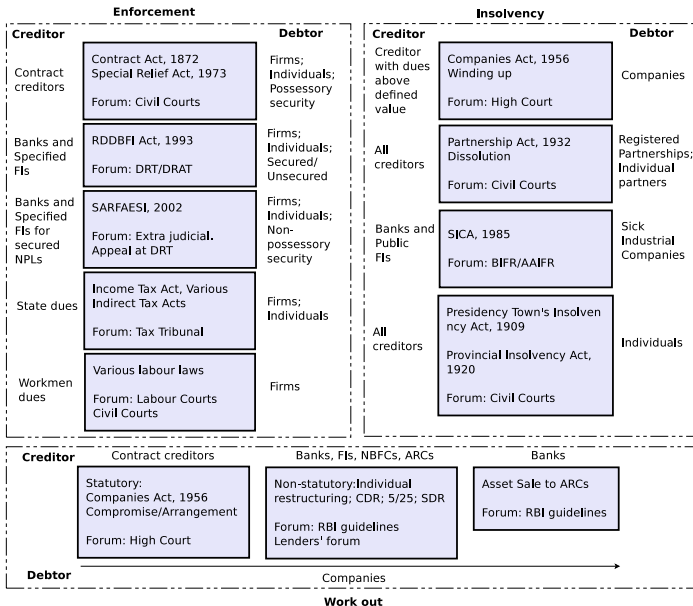


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# Economic and Legal outcomes

# Enforcement framework outcomes

- ▶ Average time to enforce contracts (WBDB) - 4 years, can go up to 20 years.
- ▶ 33 DRTs, 60,000 pending cases. Recovery rates - 14%.
- ▶ 12.5 lakh SARFAESI referrals in 2015. Recovery rates - 24%. Most SARFAESI cases end up as appeals in DRT.



# Insolvency framework outcomes

- ▶ 9.5 lakh active companies in India in 2014. Around 60,000 - 70,000 new companies added every year. Only around 300 - 400 new winding up cases in High Courts. Around 4,800 cases pending.
- ▶ Winding up takes an average of 4-5 years, some cases even 25 years.
- ▶ At BIFR, total of around 5,900 cases over three decades. Only one BIFR bench. Average time taken 5.8 years.
- ▶ 65% of BIFR referrals found not sick. Scheme sanctioned in only in 10% cases.

# Work out

- ▶ CDR used by banks to restructure significant amounts of debt: 530 cases with total debt of Rs. 4 trillion (around 7% of banking sector advances).
- ▶ Successful exit in 16% cases. 38% failed and 46% ongoing.
- ▶ 15 SDR cases (till December 2015) with debt of Rs. 0.8 trillion. 11 cases are from CDR and 2 from CDR group companies.
- ▶ 14 ARCs. Banks? stressed advances - 11% of assets. Sale to ARCs - 0.8%.
- ▶ *Extend and pretend* rather than *resolution*.

# Problem 1 on legal outcomes: high uncertainty

- ▶ Legal framework: complex, fragmented.  
Broken insolvency framework.
- ▶ Insufficient institutional capacity: courts, professional services, information systems.  
Even strong laws like RDDBFI and SARFAESI did not improve recovery.
- ▶ Unclear priority between laws and between fora.  
Conflicts are decided by litigation. Lack of clarity causes delays.
- ▶ Arbitrage: differential access, varied procedures.  
Forum shopping.

**Low predictability of resolution, high pendency, high cost, poor recovery.**

# Problem 1 on legal outcomes contd: high uncertainty

- ▶ Trigger is either too early or too late
  - ▶ SICA: 50% of net worth
  - ▶ Winding Up: Default worth INR 500
  - ▶ SARFAESI: 90 days of NPA declared
- ▶ No collective action process.
- ▶ Distribution waterfall is complex and uncertain.

## Problem 2 on economic outcomes: poor credit markets

	India	U.S.A.	U.K.	Singapore	Canada
<b>Resolving Insolvency (Rank)</b>	136	5	13	27	16
• Time (Years)	4.3	1.5	1	0.8	0.8
• Recovery rate (cents per \$)	25.7	80.4	88.6	89.7	87.3
<b>Getting Credit (Rank)</b>	42	2	19	19	7
• Credit to non-financial sector (% of GDP)	59.5	149.8	156.3	144.8	203.9
• O/w bank credit (% of total)	93.5	33.4	57.0	85.4	51.1

Source: World Bank: Doing Business, 2015;

BIS: long series on total credit to non-financial sectors, 2015

**Under-developed credit markets, bank dominance.**

## Problem 3 on economic outcomes: low debt-financing for firms

	1991-92	2009-10	2012-13
Equity	22.6	34.9	37.2
Retained earnings	10.6	21.0	6.8
Fresh issuance	12.0	13.8	30.4
Depreciation	17.6	9.7	3.6
Borrowing	35.3	29.5	21.6
Banks	17.1	17.8	15.2
Bonds	7.9	3.9	0.9
Inter-corporate	1.3	2.3	3.3
Foreign	5.5	3.2	0.7
Current liabilities	24.4	24.2	37.7
D:E	1.56	0.85	0.58
Secured	54.9	60.3	63.8
Unsecured	45.1	39.7	34.4

Source: CMIE Prowess

**Limited access to long term debt, undue reliance on secured debt.**

## Problem 4 on economic outcomes: banking sector stress

	2011	2012	2013	2014	2015
Advances (Rs. trillion)	40.8	48.0	55.3	62.8	68.8
GNPA (%)	3.3	2.9	3.4	4.1	4.5
Restructured advances (%)	3.5	4.7	5.8	5.9	6.4
Total Stressed advances (%)	6.8	7.6	9.2	10.0	10.9

Source: RBI

**Real sector stress translates into banking stress.  
Precipitated by the lack of exit choices.**

## **Part III: Reforms of Indian bankruptcy**



# Previous reform efforts

Year	Committee	Key recommendation	Outcome
1964	24th Law Commission	Merge Presidency and Provincial Insolvency Acts	Amendments to the Provincial Insolvency Act, 1929
1981	Tiwari Committee (GOI)	Mechanism to deal with industrial sickness	SICA, 1983. BIFR and AAIFR set up.
1991	Narasimham Committee I (RBI)	Special tribunal for recovery claims of financial institutions	RDDBFI Act, 1993. DRT and DRAT set up.
1998	Narasimham Committee II (RBI)	ARCs to deal with banking NPAs	SARFAESI Act, 2002
1999	Justice Eradi Committee (GOI)	Setting up of NCLT/NCLAT. Reorganisation to be merged in Companies Act. Repeal of SICA	Companies (Amendment) Act, 2002. Not notified
2001	L. N. Mitra Committee (RBI)	A comprehensive bankruptcy code	-
2005	Irani Committee (GOI)	Amendment to winding up under the Companies Act, inclusion of reorganisation	Companies Act, 2013. Insolvency chapters not notified
2008	Raghuram Rajan Committee (GOI)	Improvements to credit infrastructure and the insolvency framework	-
2014	Bankruptcy Law Reforms Committee (GOI)	Replacing extant laws with a single consolidated Insolvency and Bankruptcy Code	IBC, 2016.

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<sup>1</sup> Source: "Evolution of the insolvency framework for non-financial firms in India", Sengupta et al, 2016 ▶

# Errors in reforms policy

- ▶ Focused on a narrow problem for a limited group of credit market participants.  
Example 1: SICA only for industrial companies that are sick.  
Example 2: DRTs and SARFAESI only for banks and some financial institutions.  
Example 3: ARCs only for NPAs of banks.
- ▶ No action on comprehensive reform proposals.  
Example: Mitra Committee, Rajan Committee.
- ▶ Focus on strengthening laws, not implementation.  
Example: DRT recovery rate 14%. Pendency 2 – 3 years. Cases worth Rs. 3.8 trillion pending.

# **The approach adopted by the Bankruptcy Law Reforms Committee**

# Insolvency and Bankruptcy Code, 2016: Design principles

1. A systemic reform, a unified code. Multiple laws will be replaced by a single law.
2. IBC provides clarify of control between equity and debt. When a firm defaults, control should transfer from equity to debt holders.
3. IBC enables symmetry of information between creditors and debtors.
4. IBC ensures a time-bound process to better preserve economic value.
5. IBC ensures a collective decision making process.
6. IBC will facilitate viability assessment of the enterprise by private individuals. This protects organisational capital, in a sensible way. A commercial decision taken by creditors.
7. The judiciary's role under IBC is to ensure legal processes are followed.

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- ▶ The Code provides for three new institutions to support the resolution process.
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    - ▶ Shorter time to resolve
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- ▶ Courts which are involved only in ensuring procedural correctness.



# Insolvency and Bankruptcy Code, 2016: Design

- ▶ When an enterprise is in distress IBC has the process to
  - ▶ resolve insolvency as Step 1, and
  - ▶ resolve bankruptcy as Step 2.
- ▶ The Step 1 process to resolve insolvency is called the Insolvency Resolution Process (IRP).
- ▶ IRP is a combination of trigger, process and time limits.

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# How is the IBC different? Design features

- ▶ Anyone with an *undisputed credit claim* can trigger: operational creditor, financial creditor, debtor.
- ▶ Benefits:
  - ▶ Difficult to create a carefully coordinated effort to hide distress.
  - ▶ Comforts creditors about future performance on their credit contracts.
  - ▶ Makes for an easier environment for creditors to then lend more readily.

# How is the IBC different? Design features

- ▶ An automatic moratorium on any fresh claims on the firm - a calm period where firm is kept as a going concern to assess solvency.
- ▶ A regulated insolvency professional can take over the management of the firm.
- ▶ The Creditors' Committee is responsible for all commercial decisions related to the firm.
- ▶ Committee receives resolution plans for revival, buyout etc.
- ▶ A plan that gets 75% votes in the committee goes through.
- ▶ IRP is time bound: 180 days with a one-time extension of 90 days.

# How is the IBC different? Design features

- ▶ Liquidation:
  - ▶ Failure of the creditors' committee to reach an agreement during the period stipulated above or
  - ▶ A decision of the creditors' committee to proceed with liquidation during the IRP; or
  - ▶ Failure of the debtor to adhere to terms of the resolution plan approved by the adjudicator.
- ▶ IBC specifies a clear waterfall of priorities under liquidation.

## Part IV: Way Forward

# Implementation: Cautious optimism

- ▶ Passing the law is the beginning.
- ▶ Enacting the new law or getting a higher score in the Doing Business rankings are not the end-goal.
- ▶ Effective implementation needs setting up the pillars of infrastructure explicitly provided for in the law.
- ▶ Adequate capacity building, clarity on transition provisions and on interactions of IBC with existing laws are needed.
- ▶ Important to have a well equipped and trained judiciary to deal with cases under the new law.

# Implementation: Where are we on this project now?

- ▶ IBC was passed as law on May 13, 2016 in both houses of Parliament.
- ▶ The adjudication forum for insolvency and bankruptcy of registered companies and LLPs will be the NCLT and NCLAT.
- ▶ The implementation of the law has started at the Ministry of Corporate Affairs.



# Big tests for IBC

- ▶ Questions going forward:
  - ▶ When will the law be notified?
  - ▶ How vulnerable will it be to litigation?
  - ▶ What will the first transactions be? When?

**Thank you.**

Research work on Indian bankruptcy:  
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