

# Information infrastructure for the bankruptcy process

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# Let's be choosy about what problems we solve in the Indian Bankruptcy Code



# Part I

## Eliminating delays after default

# What we learned from Lehman

- On 15 September 2008, Lehman filed for bankruptcy.
- Things got quite complicated because it was a complex firm.
- A large number of counterparties had complex claims upon the firm.
- This created complexities in resolution.
- *Solution*: Regulators worldwide are pushing in favour of complete databases about all aspects of a firm, which can yield a ready database when resolving.
- In the US: Office for Financial Research.
- In India: FSLRC has recommended 'Financial Data Management Centre' (FDMC). On 30 September 2014, MOF created a 'Task Force' for implementing FDMC.

# This is an issue for many firms, not just SIFIs

- Resolving Lehman is truly complicated.
- What about resolving Kingfisher? This requires a full picture of:
  - Multiple bond issues and the terms and conditions on each;
  - Multiple loans and the terms and conditions on each;
  - The assets which are locked away for secured credit vs the assets which are not;
  - Waterfall structures.
- Once a firm gets into trouble, all creditors need to know where all creditors stand, in order to negotiate their way forward.
- Once a firm gets into trouble, every single day of delay is costly.
- *PROPOSAL 1*: Can we centralise information, in a database, about claims and pledges, so that it's instantly available?

# How to implement this

- All credit goes through a financial firm – either an investment banker (for bond issuance) or a bank (for loans). A regulation can be written which requires e-filing to FDMC.
- Upon default, all this information should become immediately available to all creditors.
- Occasionally there would be a transaction which slips this database. It's not a show stopper.<sup>1</sup>
- A regulator can run sample studies and report on the extent of incompleteness of this data, on average, so that everyone can keep this in mind.

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<sup>1</sup>This would never be an arms-length investor.

# Cost-benefit analysis

**Cost** There is a fixed cost of back-office system development in banks and in investment banks. After that, e-filing of data is essentially free.

## Benefits

- This will eliminate many weeks of coordination time and reduce the cost of bankruptcy by reducing the delay.
- Upon default, all creditors would immediately know the list of all creditors and would be in touch with each other.
- It will eliminate staff time of various creditors finding each other and agreeing on what their rival claims / pledged assets are.

## Part II

# A market efficiency perspective



# Equity, debt and firm value

- The overall assets of a company are  $V$
- This value is split between equity and debt.
- Equity is a call option on the assets of the company: keep all the upside in liquidation above the strike price  $D$ .
- A corporate bond is similarly a government bond minus a put option price.

## More complex structures are common

Senior debt  
Subordinated debt  
Equity

First claim  
Second claim  
Upside

More complex option pricing calculations.

# How to price a claim?

- How is a speculator to value a share?
- How is a speculator to value a corporate bond or a loan?
- Conventional accounting data lets the speculator understand the pizza, but not how it's sliced up.
- E.g. in order to value a corporate bond, the speculator requires full information about the claimants on the firm.
- Complete information about all claims is essential!
- *Equity* valuation depends on whether a firm in default can be kept as a going concern!
- *PROPOSAL 2*: The full database about claims and pledges should be placed into the public domain, once a company has even one listed security.

## Part III

# Information about default or restructuring

# The present Indian situation

- At present, in India, default is a family secret.<sup>2</sup>
- It is rumoured that firms selectively default on some powerless bondholders (i.e. the public) while paying bondholders who can make trouble (i.e. institutional investors).  
(The draft Indian Financial Code requires equal treatment of all holders of a given ISIN, and punishes violations of this).
- However, default on any one claim is extremely material information for all claimants (loans / bonds / shares).
- Restructuring of any one set of debt obligations is, similarly, a very big event which shapes the valuation of all other claims.

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<sup>2</sup>Wockhardt defamation case.

## Transparency about default / restructuring

- *PROPOSAL 3*: SEBI must write a regulation, which affects all listed companies, which says that if a firm defaults to any creditor, this information must be disclosed on the same day. Details about restructuring must, similarly, be released on the same day.
- *PROPOSAL 4*: NSDL/CDSL know about every corporate bond. Coupon/principal repayments should be routed through them, and then they would track contract performance. This would put an end to selective default on corporate bonds. Using NEFT, there need be no delays in money moving : firm → depositories → bondholders.

## Downstream effects

- Under these proposals, the credit ecosystem will become better:
  - A defaults database will be available, and everyone would analyse the predictors of failure and improve pricing.
  - When a financial player deals with firm  $i$  today, he is worried that actually there is distress which has been kept hidden. The fact that a certain firm is behind in its payments is precious secret information in Bombay, and generates a rent for the Bombay community. In an environment of full transparency, this asymmetric information is eliminated.

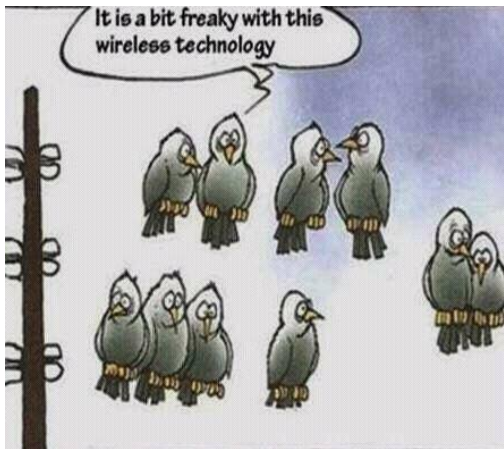
## Part IV

Why is this different from what we see elsewhere?



# Importance of first principles reasoning

- Many institutional arrangements in the first world were setup before modern computer technology.
- It is important to not merely accept those solutions as the best ones.
- E.g. in securities markets, India has generally been ahead of the 'global state of the art'. Indian thinking often ignored the 'US model'.



## Prise open an opaque system

*“The philosophers have only interpreted the information set, in various ways. The point, however, is to change it.”*



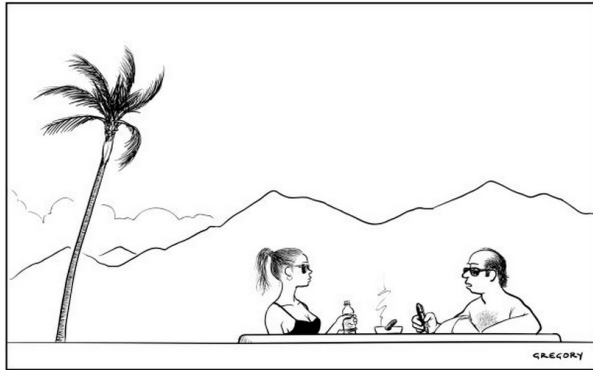
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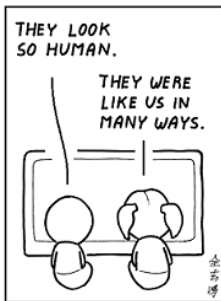
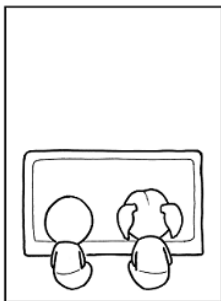
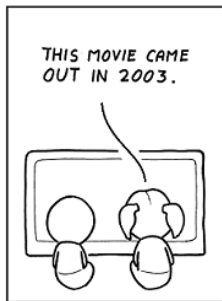


- The world of corporate debt is shrouded in secrecy.
- This is inefficient – it increases bankruptcy costs and reduces market efficiency.
- It hampers entry from beyond the cosy Bombay club.
- Using modern technology, we can end the opacity, eliminate rents, increase market efficiency, reduce the cost of capital.
- This is a recurring meme in modern finance.

# Many elements of mainstream Western institutions are quaint



*"I still compose my tweets in longhand on a yellow legal pad."*



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# Part V

## Conclusion

## Summary: Four proposals

The problems of information processing and coordination between claimants can be reduced by four initiatives:

- 1 Maintain a master database of claims and pledges.
- 2 Make this public at all times: This will assist valuation of securities and reduce coordination problems upon default.
- 3 Immediate disclosure of default or restructuring (with the terms of restructuring).
- 4 Route coupon/principal payments through depositories, so as to ensure reporting of default.

## Loose ends

- Where does the debenture trustee come into all this?
- What are connected provisions in Companies Act, 2013?
- What would BLRC recommend as future SEBI regulations?
- What would BLRC recommend as market infrastructure to be built by FMIIs, encouraged by MoF?
- What would need to go into Indian Bankruptcy Code?



Thank you.

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