Reform of the bankruptcy framework in India

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What is a bankruptcy framework

- A bankruptcy framework lays down rules for what will happen in the case of a business failure.
- The process is, most often, triggered when an entity defaults on its dues. This is known as insolvency.
- Bankruptcy is the formal determination of insolvency with resulting legal steps to deal with it.
- An optimal framework creates a degree of certainty for both the creditors and the debtors on the outcome of business failure.
Why do we need a bankruptcy framework?

- Incomplete and mutually inconsistent contracts.
- Information asymmetry between firms and its lenders.
- Secured versus unsecured credit.
- Enabling risk-taking and enterprise.
- Preserving the going concern value of an enterprise.
- Reducing strategic behaviour.
The goals of a bankruptcy framework

- Four principal goals:
  - To enhance the value of the failing debtor.
  - To distribute this value efficiently and optimally.
  - To internalise the costs of the business failure to the parties dealing with the debtor.
  - To create optimal incentives, for both debtors and creditors, ex-ante and ex-post.
Design of an optimal bankruptcy process

- Much debate on what is an optimal process. The choices:
  - Liquidation vs. re-organisation focused
  - Creditor friendly vs. debtor friendly
  - Court driven vs. rule driven

- Actual bankruptcy laws vary widely across countries depending on:
  - Underlying economic and institutional conditions.
  - Path-dependence of economic and institutional development.
  - Political economy factors.

- The design of the framework has an impact on behaviour of creditors and debtors in pre and post bankruptcy states.
The Indian framework

Insolvency Resolution Mechanisms
India’s performance vis-a-vis other countries

<table>
<thead>
<tr>
<th></th>
<th>India</th>
<th>U.S.A.</th>
<th>U.K.</th>
<th>Australia</th>
<th>Singapore</th>
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<tbody>
<tr>
<td><strong>Getting Credit (Rank)</strong></td>
<td>28</td>
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<td>• Index of legal rights strength (1...10)</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>10</td>
<td>10</td>
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<td>• Private bureau coverage (%)</td>
<td>19.8</td>
<td>100</td>
<td>100</td>
<td>100</td>
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<td><strong>Enforcing Contracts (Rank)</strong></td>
<td>186</td>
<td>11</td>
<td>56</td>
<td>14</td>
<td>12</td>
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<tr>
<td>• Time (Days)</td>
<td>1420</td>
<td>370</td>
<td>437</td>
<td>395</td>
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<td>• Procedures (No.)</td>
<td>46</td>
<td>32</td>
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<td><strong>Resolving Insolvency (Rank)</strong></td>
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<td>7</td>
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<td>4</td>
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<tr>
<td>• Time (Years)</td>
<td>4.3</td>
<td>1.5</td>
<td>1</td>
<td>1</td>
<td>0.8</td>
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<tr>
<td>• Recovery rate (cents per $)</td>
<td>25.6</td>
<td>81.5</td>
<td>88.6</td>
<td>81.3</td>
<td>89.4</td>
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<tr>
<td><strong>Domestic Credit by financial sector (% of GDP)</strong></td>
<td>77.1</td>
<td>246.1</td>
<td>195.6</td>
<td>158.8</td>
<td>112.6</td>
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</table>

Where we are in India today

- Banks are focused on secured credit. Yet there is a crisis of NPAs on their balance sheets.
- There corporate bond market has not taken off.
- Most firms are unable to access credit.
- The laws and institutions for dealing with failing firms are complicated and inefficient.
- As result promoters are forever.
Reform of the bankruptcy framework in India

Reforming bankruptcy law

- The international experience: considerable interest in reform of bankruptcy law in the last 20 years.
- A variety of triggers:
  - The east Asian Crisis and subsequent reforms
  - The fall of socialism in East Europe,
  - The desire to promote entrepreneurship – UK (2002), Brazil (2004), Korea (2011, 2013)
  - Prevention of abuse of bankruptcy law – USA (2005)
- In India, we have tried piecemeal reforms.
  - SICA, 1985
  - RDDBFI, 1993
  - SARFAESI, 2002
  - CDR guidelines
- The IFC already provides for a Resolution Corporation for financial firms.
- Is it time to address this problem comprehensively for non-financial firms?
Considerations for reform of bankruptcy in India

- Re-writing the law – creating a comprehensive code for all enterprises and all creditors.
- Reform of the institutional setting – dealing with court capacity and judicial delays.
- Strengthening ancillary institutions – credit bureaus, collateral registry, insolvency professionals.
- Incentive structures of state owned financial institutions.
- Interaction of bankruptcy laws with other laws governing industries, labour, transfer of property.
- Interaction of corporate insolvency with individual insolvency.