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
  - Collective action
  - Liquidation

  SARFAESI
  Absent
  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 RDDBFI 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- All existing frameworks must be repealed to give way to a single coherent and simple approach.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 an 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.