Indian bankruptcy reform

May 14, 2016
Outline

- Elements of a sound insolvency system
- The present framework
- The IBC approach
Part I

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, (3) lower collateral requirement, and (4) from a greater number and variety of lenders.
The economics of insolvency reform

▶ Breadth and depth of credit markets

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▶ Commercial confidence and predictability

When insolvency systems function, lenders can price risk more accurately and manage it more effectively.
The economics of insolvency reform

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▶ Balance in commercial relations

More responsible behaviour by debtors and creditors. Improved corporate governance.
The economics of insolvency reform

- **Breadth and depth of credit markets**

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- **Commercial confidence and predictability**

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- **Balance in commercial relations**

  More responsible behaviour by debtors and creditors. Improved corporate governance.

- **Efficient allocation of assets and stability**

  The possibility of exit promotes entrepreneurship. Effective exit provides a safety valve for corporate distress.
## The credit continuum

<table>
<thead>
<tr>
<th>Credit access</th>
<th>Financial distress</th>
<th>Enforcement/insolvency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit assessment</td>
<td>Risk assessment</td>
<td>Enforcement</td>
</tr>
<tr>
<td>Information</td>
<td>Information</td>
<td>Security rights</td>
</tr>
<tr>
<td>Identify security</td>
<td>Identify options</td>
<td>Formal insolvency</td>
</tr>
<tr>
<td>Negotiate pricing</td>
<td>Negotiate pricing</td>
<td>Information</td>
</tr>
<tr>
<td>Contracting</td>
<td><strong>Amend contracts</strong></td>
<td>Negotiation</td>
</tr>
<tr>
<td>Registry</td>
<td><strong>Possible action</strong></td>
<td>Implementation</td>
</tr>
<tr>
<td>Monitoring</td>
<td>Monitoring</td>
<td>Monitoring</td>
</tr>
</tbody>
</table>

Source: World Bank
Part II

What is wrong with the present framework?
Enforcement framework

- 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

- 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 either abated or found not sick. Scheme sanctioned in only in 10% cases.

- Individual insolvency laws barely used. Banks and eligible FIs use DRTs or SARFAESI. Other lenders take security cheques and use provisions of Negotiable Instruments Act.
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).

- 65% of packages between 2010 – 2014, regulatory forbearance given.

- 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*. 
Where we are

- Legal framework: complex, fragmented.
- Priority: unclear, between laws and between fora.
- Arbitrage: differential access, varied procedures.
- Institutional capacity: insufficient, courts, professional services, information systems.

**Problem 1: low predictability, high pendency, high cost, poor recovery.**
Comparison with other common law countries

<table>
<thead>
<tr>
<th>Enforcing Contracts (Rank)</th>
<th>India</th>
<th>U.S.A.</th>
<th>U.K.</th>
<th>Singapore</th>
<th>Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time (Days)</td>
<td>1420</td>
<td>370</td>
<td>437</td>
<td>150</td>
<td>570</td>
</tr>
<tr>
<td>Cost (% of claim)</td>
<td>39.6</td>
<td>22.9</td>
<td>43.9</td>
<td>25.8</td>
<td>22.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Resolving Insolvency (Rank)</th>
<th>India</th>
<th>U.S.A.</th>
<th>U.K.</th>
<th>Singapore</th>
<th>Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time (Years)</td>
<td>4.3</td>
<td>1.5</td>
<td>1</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Recovery rate (cents per $)</td>
<td>25.7</td>
<td>80.4</td>
<td>88.6</td>
<td>89.7</td>
<td>87.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Getting Credit (Rank)</th>
<th>India</th>
<th>U.S.A.</th>
<th>U.K.</th>
<th>Singapore</th>
<th>Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit to non-financial sector (% of GDP)</td>
<td>59.5</td>
<td>149.8</td>
<td>156.3</td>
<td>144.8</td>
<td>203.9</td>
</tr>
<tr>
<td>O/w bank credit (% of total)</td>
<td>93.5</td>
<td>33.4</td>
<td>57.0</td>
<td>85.4</td>
<td>51.1</td>
</tr>
</tbody>
</table>

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

Problem 2: credit markets under-developed, dominated by banks.
Access to finance

- Firm D:E ratios have declined over time – from 1.6 in 1991-92 to 0.6 in 2012-13. Equity issuance (30%) and trade credit (38%) main sources.

- Banking sector the largest source of long-term financing credit firms (70%). Bonds only a fraction (5%).

- Personal loans – 0.05 bn accounts, 16% banks’ advances. 75% secured.

Problem 3: limited access to credit. Undue reliance on security.
Banking sector stress

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advances</td>
<td>40.8</td>
<td>48.0</td>
<td>55.3</td>
<td>62.8</td>
<td>68.8</td>
</tr>
<tr>
<td>Y-o-y growth in advances (%)</td>
<td>21.8</td>
<td>17.6</td>
<td>15.2</td>
<td>13.6</td>
<td>9.6</td>
</tr>
<tr>
<td>GNPA (%)</td>
<td>2.5</td>
<td>2.4</td>
<td>3.4</td>
<td>4.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Restructured advances (%)</td>
<td>5.0</td>
<td>5.8</td>
<td>5.8</td>
<td>6.0</td>
<td>6.4</td>
</tr>
<tr>
<td>Stressed advances (%)</td>
<td>7.5</td>
<td>8.2</td>
<td>9.2</td>
<td>10.2</td>
<td>11.1</td>
</tr>
</tbody>
</table>

Source: RBI

Problem 4: real sector stress translating into financial sector stress.
Part III

The IBC approach
0. A systemic reform: Multiplicity of laws replaced by a single law.

1. Clarify control between equity and debt: When firm defaults, control should transfer to the debt holders. Respect for limited liability.

2. Protect organisational capital, in a sensible way: failure is a possibility, viability a commercial decision. Not all failure is theft/fraud.

3. Calm period: firm is immune to the claims of creditors; firm is managed by an Insolvency Professional reporting to creditors.

4. Liquidation: Clear waterfall of priorities.

5. Humane approach: balance of interest between creditor and debtor. Fresh start to individuals.


7. The role of the judiciary: Ensure legal processes are followed.
Thank you.