Indian bankruptcy reform

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Outline

- First principles
- The Indian framework
- Why reform?
- The IBC approach
Part I

First principles
Enterprise needs capital: equity, debt.

Debt enables larger projects to be undertaken, without diluting ownership interest.
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For lenders, two things matter: the probability of default (PD), and the loss given default (LGD).

The first is credit decision, the second recovery.
Enterprise needs capital: equity, debt.

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The limited liability bargain:

1. Firms’ shareholders accept disclosure and agree to work with lenders within the bankruptcy framework
2. In return, their liability gets capped. Shareholders get to keep their Mercedes Benz even when the firm is in default
A firm’s distress can be financial or economic.
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1. If its financial, restructuring may enable it to survive. This is good for the economy.
2. If it is economic, it needs to close down, releasing capital and resources. This too is good for the economy.
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Capitalism is all about trying new ideas, products and technologies, even though they may fail. There’s nothing wrong or immoral about failure.

An mechanism that allows failed firms to exit enables innovation and growth.
Individuals too need debt: for enterprise or for smoothing consumption.

Individuals who can’t repay debt need a humane mechanism to exit these debts and get a fresh start.
Part II

The Indian framework
How it evolved

Insolvency Resolution Mechanisms

- **Partnerships and proprietors:**
  - Presidency Towns Insolvency Act, 1909 and Provincial Insolvency Act, 1920

- **Industrial companies defined as sick under SICA, 1985:**
  - Winding up/liquidation under Companies Act, 1956

- **Rehabilitation under SICA, 1985:**
  - Bank/PFI loans to firms and individuals under RDDBFI Act, 1993

- **Winding up and rehabilitation under Companies Act, 2013:**
  - CDR guidelines, 2002
  - Bank/PFI secured loans to firms and individuals under SARFAESI Act, 2002
  - 2013 amendment to the Companies Act

- **Firms incorporated as companies under the Companies Act, 1956:**
  - CDR for firms by banks/PFIs
Where we are

**Enforcement**
- **Creditor**
  - Contract creditors
    - Contract Act, 1872
    - Special Relief Act, 1973
    - Forum: Civil Courts
  - Banks and Specified FIs
    - RDDBFI Act, 1993
    - Forum: DRT/DRAT
  - Banks and Specified FIs for secured NPLs
    - SARFAESI, 2002
    - Forum: Extra judicial. Appeal at DRT
  - State dues
    - Income Tax Act, Various Indirect Tax Acts
    - Forum: Tax Tribunal
  - Workmen dues
    - Various labour laws
    - Forum: Labour Courts Civil Courts
- **Debtor**
  - Firms; Individuals; Possessory security
  - Firms; Individuals; Secured/Unsecured
  - Firms; Individuals; Non-possessory security
  - Firms; Individuals
  - Firms

**Insolvency**
- **Creditor**
  - Creditor with dues above defined value
    - Companies Act, 1956
    - Winding up
    - Forum: High Court
  - All creditors
    - Partnership Act, 1932
    - Dissolution
    - Forum: Civil Courts
  - Banks and Public FIs
    - SICA, 1985
    - Forum: BIFR/AAIFR
  - All creditors
    - Presidency Town's Insolvency Act, 1909
    - Provincial Insolvency Act, 1920
    - Forum: Civil Courts
- **Debtor**
  - Companies
  - Registered Partnerships; Individual partners
  - Sick Industrial Companies
  - Individuals

**Workout**
- **Creditor**
  - Contract creditors
    - Statutory: Companies Act, 1956
    - Compromise/Arrangement
    - Forum: High Court
  - Banks, FIs, NBFCs, ARCs
    - Non-statutory: Individual restructuring; CDR; 5/25; SDR
    - Forum: RBI guidelines
    - Lenders’ forum
  - Banks
    - Asset Sale to ARCs
    - Forum: RBI guidelines
- **Debtor**
  - Companies
  - Work out
Enforcement framework

- Average time to enforce contracts (WBDB) – 4 years, can go up to 20 years.

- DRTs:
  - 1.7 lakh cases worth Rs. 3.7 trillion referred in 2015.
  - 83,000 pending cases.
  - Recovery rates – 14%.

- SARFAESI:
  - 12.4 lakh cases worth Rs. 4.7 trillion under SARFAESI in 2015.
  - Recovery rates – 24%.
Enforcement framework

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Insolvency framework

- Winding up:
  - 9.5 lakh active companies in India in 2014. Around 60,000 – 70,000 added every year. Only 300 – 400 new winding up cases in High Courts. 4,800 winding up cases pending.
  - Average time to wind up: 4-5 years.

- Rehabilitation via BIFR:
  - 5,800 cases over three decades.
  - Only one BIFR bench. Average time taken 5.8 years.
  - 65% of BIFR cases abated or found not sick.
  - Schemes sanctioned in 10% cases.

- Individual insolvency:
  - Laws barely used.
  - Banks and eligible FIs use DRTs or SARFAESI. Other lenders use Arbitration Act or take security cheques and use provisions of Negotiable Instruments Act.
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Work outs

- CDR:
  - 655 cases referred between 2002 – 2015. Of these 65% of between 2010 – 2014, when regulatory forbearance was given.
  - Sanctioned in 530 cases, total debt of Rs. 4 trillion (around 7% of banking sector advances).
  - Successful exits 16%, failed exits 38%, ongoing 46% ongoing.

- Similar challenges with other schemes like SDR and S4A.
- Private resolution through the ARC mechanism plagued with regulatory and other challenges.
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Part III

Why reform?
Broken insolvency framework

- Legal framework: complex, fragmented.
  No concept of time value of money.
- Priority: unclear, between laws and between fora, between lenders and their rights.
  In distress, pre-insolvency priority does not hold.
- Arbitrage: differential access, varied procedures.
  Stacked in favour of banks and FIs.
- Institutional capacity: insufficient, courts, professional services, information systems.
  No capacity to deal with the demands of a growing economy.
## Broken insolvency framework

<table>
<thead>
<tr>
<th></th>
<th>India</th>
<th>U.S.A.</th>
<th>U.K.</th>
<th>Singapore</th>
<th>Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Enforcing Contracts (Rank)</strong></td>
<td>178</td>
<td>21</td>
<td>33</td>
<td>1</td>
<td>49</td>
</tr>
<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>
<tr>
<td><strong>Resolving Insolvency (Rank)</strong></td>
<td>136</td>
<td>5</td>
<td>13</td>
<td>27</td>
<td>16</td>
</tr>
<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>

### Under developed credit markets

<table>
<thead>
<tr>
<th>Getting Credit (Rank)</th>
<th>India</th>
<th>U.S.A.</th>
<th>U.K.</th>
<th>Singapore</th>
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</tr>
</thead>
<tbody>
<tr>
<td>42 2 19 19 7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<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
Limited access to debt finance for firms

<table>
<thead>
<tr>
<th>Source: CMIE Prowess</th>
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<table>
<thead>
<tr>
<th>As % of total</th>
<th>1991-92</th>
<th>2009-10</th>
<th>2012-13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>22.60</td>
<td>34.87</td>
<td>37.21</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>10.56</td>
<td>21.05</td>
<td>6.85</td>
</tr>
<tr>
<td>Fresh issuance</td>
<td>12.04</td>
<td>13.82</td>
<td>30.36</td>
</tr>
<tr>
<td>Depreciation</td>
<td>17.64</td>
<td>9.69</td>
<td>3.56</td>
</tr>
<tr>
<td>Borrowing</td>
<td>35.32</td>
<td>29.48</td>
<td>21.57</td>
</tr>
<tr>
<td>Banks</td>
<td>17.14</td>
<td>17.83</td>
<td>15.20</td>
</tr>
<tr>
<td>Bonds</td>
<td>7.87</td>
<td>3.94</td>
<td>0.96</td>
</tr>
<tr>
<td>Inter-corporate</td>
<td>1.28</td>
<td>2.28</td>
<td>3.32</td>
</tr>
<tr>
<td>Foreign</td>
<td>5.51</td>
<td>3.22</td>
<td>0.74</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>24.42</td>
<td>24.19</td>
<td>37.65</td>
</tr>
<tr>
<td>D:E</td>
<td>1.56</td>
<td>0.85</td>
<td>0.58</td>
</tr>
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Banking sector stress

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<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>
<td>73.2</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>
<td>7.6</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>
<td>3.9</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>
<td>11.5</td>
</tr>
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Source: RBI
Why reform?

- Better 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.
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▶ Commercial confidence and predictability

When insolvency systems function, lenders can price risk more accurately and manage it more effectively.
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- Balance in commercial relations
  More responsible behaviour by debtors and creditors. Improved corporate governance.
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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.
Part IV

The IBC approach
1. A systemic reform, not tinkering. Many laws replaced by a single comprehensive law.

2. Clarify control between equity and debt. Respect for limited liability.

3. Protect organisational capital, in a sensible way. Failure is a possibility, viability a commercial decision.

4. A calm period to consider resolution, collectively. Firm is immune to the claims and suits; managed by a Professional reporting to creditors.

5. Liquidation: Clear waterfall of priorities.

6. Need for speed. Use technology speed up the process, avoid disputes.

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