

Indian bankruptcy reform

November 15, 2015

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

SARFAESI

Collective action

Absent

Liquidation

Failed

- RBI came up with a few attempts e.g. CDR. Banks only.
- Divine right of promoters
- Capital and labour get interminably stuck.
- Bottom line: recovery rate of perhaps 20%.

Consequences

- NPA problems of banks?
- The real issues run deeper.

Consequences

- NPA problems of banks?
- The real issues run deeper.
- We gave power to some secured creditors under 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.

The full picture on insolvency

	Domestic	Cross-border
Financial firms with high intensity promise or systemically important	FSLRC	Not begun
All other firms	BLRC	Not begun
Individual insolvency	BLRC	Not applicable.

On 30 September 2014, MOF setup a 'Task Force on Establishment of the Resolution Corporation', chaired by M. Damodaran, which is building a specialised institutional capability for dealing with financial firms which have high intensity promises or are systemically important.

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- All existing frameworks must be repealed to give way to a single coherent and simple approach.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

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. Insolvency professionals

- A new regulated person, the 'IP'
- Oversee, and ensure compliance in, the working of the Insolvency Resolution Process.
- Oversee, and ensure compliance in, the liquidation process.

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.

7. Need for speed

- The bankruptcy process must work swiftly – every day of delay imposes massive costs upon society.
- Use IT to eliminate delays and disputes about facts.

Part III

BLRC

Bankruptcy Legislative 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 the minds of 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 a 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 Insolvency Professionals
 - 2 A private competitive industry of Information Utilities
 - 3 Efficient and well functioning tribunals
 - 4 A regulator.

Insolvency professionals

- ICAI, ICSI, etc. haven't worked well.
- Exchange architecture: Regulator – exchange – member.
- Multiple competing private IP Agencies
- Each with legislative, executive and judicial functions
- Oversight of 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.

Well functioning tribunals

- NCLT is the proposed forum for corporate 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

- Grounded in sound economics
- 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 four pillars of infrastructure needs to be in the law.
- FSLRC had 2 years to draft the law, and after that, 2.2 years were taken in perfecting the law to make version 1.1 of the Indian Financial Code.

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.

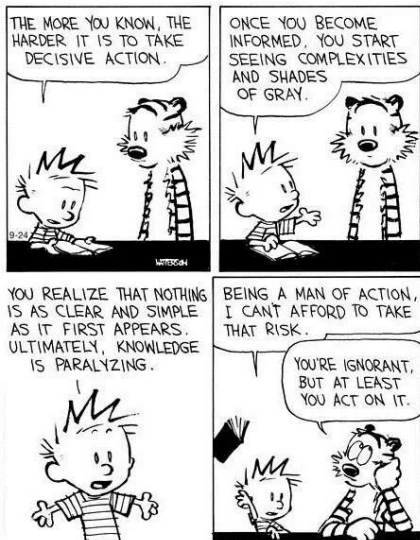
5. Insolvency professionals

- 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 great 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.