Bankruptcy reform

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Establishing a sound institutional framework governing default by borrowers- whether firms or individuals -is one of the most important elements of making debt contracts work. India has begun on this journey, with the 2016 enactment of the Insolvency and Bankruptcy Code (IBC). The law is a structural change in setting up a legal framework for insolvency resolution - a single law for all borrowers other than financial firms, with four institutional pillars created within the law for its implementation. The law was passed with alacrity and the implementation was done with full force. The regulator (Insolvency and Bankruptcy Board of India, IBBI), the insolvency professionals (IPs) and their self-regulatory agencies, the insolvency professional agencies (IPAs) have arisen with six months of the passing of the law to operationalise a new collective resolution process for firm distress. Simultaneously the National Companies Law Tribunal (NCLT) geared up to take on the role of the adjudicating authority over cases of firm insolvency resolution.

The problem

Four structural problems can be identified at present for the bankruptcy reform:

1. *Delays*. The law had envisaged that the Corporate Insolvency Resolution Process (IRP) would finish in 180 days or a within a maximum of 270 days. The empirical evidence, however, shows that in one year, only half the cases are completed. For the 12 large cases that the Reserve Bank of India (RBI) introduced for resolution when the system was barely six months old, not even 90% have been completed within this time frame.

2. *Pro-restructuring even if liquidation is economically efficient.* Bankruptcy processes involve one key principle: When a default takes place, power shifts from shareholders to the creditors. The creditors make decisions based on their best commercial interest. However, in 2018, we have seen a return of the notion that the interests of stakeholders such as the employees should be taken into account in the bankruptcy process even though they are not creditors.

3. *Recovery over procedure*. The adjudicating authority has repeatedly made decisions that are inimical to the interests of creditors with decisions that delay the process relative to the requirement of the law and raises the uncertainty for creditors and the enterprise. One common theme is the distinction between the impact of a ruling on one case as opposed to the impact of a rule on the economic system. As an example, during insolvency resolution, bids have been accepted much after the deadline has passed and a re-evaluation of bids are allowed even after a bid has been selected. When we think about one case, it may look like the outcome is improved by allowing in a late bid. But such disruptions of a defined process destroys the quality of bidding in all future auctions.

4. *Capacity constraints ballooning at key IBC institutions.* Much of the emergent delays in the current performance of the insolvency framework is because of the mismatch between the rate of emergence of the problems of enterprise distress and the ability of the key IBC institutions to deal with it. The rate at which filings are accepted at the NCLT has slowed significantly. Much of the information dissemination that the IBBI is expected to publish is not available. The development of the IU (information utilities) industry has been stalled, and the ecosystem shows increasing distrust in the ability of the IP to carry out their roles and responsibilities during the insolvency resolution process.

The task of the new government is to analyse why these four disruptions are increasingly appearing in the new insolvency system, and how to implement countermeasures to correct these.

How can these be solved?

1. *From anecdote to evidence.* The everyday working of bankruptcy reform in India today is dominated by anecdote. The discourse is dominated by practitioners, who tend to focus on outliers which are the juicy stories. Policy actions are being shaped by impressions and gossip about outliers. This needs to be replaced by an evidence-based and research-based framework. Researchers need to be brought into the reform process. This will require sustained work, and long-term investments, in creating capacity in research at multiple institutions in India and linking them into the policy process.

2. *From opacity to transparency.* The research process, within government and at academic institutions, is crippled owing to the lack of data. In order to address this, a series of actions are required.

   a. The Bankruptcy Legislative Reforms Committee (BLRC) volume 1 has a sound framework governing disclosure of default. This has not been implemented. It needs to be implemented.

   b. A case management software system, that is widely accessible, must be urgently established. There is well-established literature that the availability of detailed information about the process and outcomes improves reforms. Once a case is filed at NCLT, it should get a unique, publicly accessible, web page. All events and all legal documents should appear on this web page, with dates attached. All documents must be text searchable (i.e. not scanned images). Ideally, there should be limited barriers against access to this data; these systems must be friendly to researchers and not just cater to the interests of practitioners.

   c. The law empowers the IBBI to collect and manage data about insolvency cases. The IBBI must now undertake this on a war footing, and release plain text files of all the data that comes out of this case management system.

   d. Information management systems should ideally start with structured orders published by the NCLT, where the order fills out a form. At present, the structure of NCLT orders varies substantially, the information in them is unpredictable, and are not released in computer searchable format.

   e. The resolution plan, once chosen by the Committee of Creditors, must be part of the publicly accessible case information.

   f. The names of professionals that worked on each case must be in the public domain.

3. *Diagnosing the difficulties of IBC using a quantitative evidence-based approach.* Once the above datasets are in hand, a research process must take place to understand the sources of difficulty in IBC. This will lead to a list of changes required in the law and in the subordinate legislation. The project management must be done to (a) Establish the datasets, (b) Study the datasets, (c) Establish a report card on the performance of the ecosystem as a measure of the impact of the law, (d) Arrive at an understanding of the sources of failure, (e) Draft the modifications to the law. This process would run through 2019 and 2020. In order to ensure continuity and consistency in the approach, an independent agency must create a monthly report card, utilising the entire data that is produced by IBBI. This report card must represent the average delay and recovery rate, of cases that completed the IRP in the month, in the class of cases where the default took place no more than two years ago. These two graphs -- the delay and the recovery rate, as seen in fresh defaults -- are the most important deliverable that the bankruptcy reform must be judged against. Success in the reforms will yield reductions in the delay and increases in the recovery rate.

4. *The missing pieces of the IBC institutional apparatus*. A competitive industry of information utilities, on the lines of NSDL and CDSL, had been envisaged by BLRC. This has not come about. If anything, there may be the rise of a monopoly public sector information system -- the Public Credit Registry ("PCR") -- built by RBI. The lack of these information utilities is one direct source of enhanced delays in the bankruptcy process. The framework with multiple competing private organisations, as designed by BLRC, is superior to a public sector monopoly. Similarly, a competitive industry of competing self-regulating organisations was envisaged for the insolvency professionals, on the lines of NSE and BSE. These would be for-profit organisations that would perform regulatory functions. This has not come about.These are two important gaps that need to be addressed.

5. *Buttress the working of NCLT by building administrative capacity and capacity building of the members.* Given a rapidly escalating workload and facing gaps in adequate resources, the NCLT is being rendered increasingly mismatched for the working of the new insolvency and bankruptcy process. There is clarity today that the operational efficiency of a court/tribunal is greatly influenced by a separation of the administrative aspects from the judicial aspects. The full project planning for an operational agency, the `Indian Courts and Tribunals Service' (ICTS) has been done as part of the developmental work towards the Financial Sector Appellate Tribunal (FSAT) at the Ministry of Finance. The ICTS is vitally needed to achieve operational efficiency at NCLT. The ICTS can possibly be built in 2019 and 2020 for a smaller tribunal -- the SAT -- and then implemented for NCLT in 2021. This will require commensurate project management, and a capable leadership team, for building the ICTS.

   In addition, effort is required to increase the knowledge and awareness of the NCLT members on the economic objectives of the law to deliver decisions in a consistent manner. The best intellectuals of the country need to be drafted into this capacity building exercise. This work can proceed in parallel, while ICTS is being constructed. There are important short term versus long term tradeoffs: The time in which NCLT judges are gaining knowledge comes at the cost of time in which NCLT judges could be hearing cases. The capacity building is an excellent investment. In 2019 and 2020, 15% of the work hours of NCLT judges (i.e. 300 hours/year for each person) ought to be devoted to knowledge building, in order to deliver a stronger NCLT going forward.

6. *Strengthening banks as dominant participants in the creditor's committee:* Banks are generally an important part of the committee of creditors in all defaults. The incentives of banks are greatly shaped by RBI rules about the valuation of stressed assets. As an example, suppose a stressed loan commands a prospective recovery rate through the IBC of 50%. Suppose, at the same time, RBI permits the bank to carry this asset at a valuation of 75%. In this case, the bank has no incentive to push hard in the IBC process to see the case through to resolution. It actually *prefers* delays in recognising the additional loss of 25 percentage points.

   This shows the critical link between the performance of the bankruptcy code and banking regulation. Sound banking regulation must always have a conservative valuation of assets.The IBC has created evidence about recovery rates. RBI rules must align themselves to force banks to use valuations which are at the 25th percentile of the recovery rates as seen in the data produced by IBC.

   This calls for a one-time effort in reviewing RBI regulations and amending them. This work will be enhanced if a sound regulation-making process is implemented at RBI, on the lines of what has been done at IBBI.

7. *Shift away from the dominant use of IBC as a means to solve bank NPAs to being the centre-piece for the development of a robust credit market*. Several of the policy action and changes in the law, rules and regulations in the IBC ecosystem are made to address the problems of the banking sector. However, such actions are often at cross-purposes to developing a sound bankruptcy process for a robust credit ecosystem. For example, if recovery rates are solely documented in terms of NPA recovery for banks and do not take into account the recovery of

bidders and stressed asset managers who are an active part of the insolvency ecosystem, these will not be an accurate measure of recovery from insolvency. Inaccuracy and uncertainty about the true recovery rates will lead to a slower path towards developing a large and heterogenous base of participants in the credit markets itself. This dominant focus on creating stronger rights for banks alone as lenders is thought of as one of the factors behind the inefficacy of SARFAESI Act, 2002. An expert committee is required which will design amendments to SARFAESI to bring it in line with IBC and with modern economic thinking.

8. *Personal insolvency.* Personal insolvency is embedded in the law but these sections have not been notified. There are important and subtle questions in the implementation of these sections. The quality of the work will depend on establishing capable implementation teams, with long time horizons, which are deeply grounded in the evidence and research. Such project management will yield success by 2021.

9. *The missing pieces of a sound legal framework for insolvency and bankruptcy resolution*. There are two parts that need to put in place for this framework in India - ensuring that all pillars in the framework are present and working and ensuring that each piece is well-drafted and consistent in its form and content. On the first, there are usually three parts of a legal framework: one ensuring the rights of secured creditors, one laying out collective resolution and one defining rights in liquidation. The first is missing in India. The IBC lays out the second and third. SARFAESI was an attempt at secured creditors rights. But it was skewed towards banks as secured creditors and mostly failed in implementation. Now, new effort must be put in place to build this pillar to co-exist with the IBC. In this effort, the drafting of the law is important. A persistent complaint about the IBC itself are inconsistencies in core definitions and inconsistencies across sections of the law with respect to key elements that were laid out in the Bankruptcy Law Reforms Committee rationale. This is particularly important for the sections on liquidation as these started being used. The individual insolvency part must be notified urgently. A part on cross-border insolvency now needs to be designed, drafted and put in place.

10. *The need for long-term leadership and project management.* Much of the recent insolvency reforms has been evolving as responses to one-off problems rather than as a measured response to improve the efficiency of the overall insolvency system. There have been short-term projects to quickly draft the law, amend the law, and set up a regulator. The short-term nature has hampered sound diagnosis and inhibited solutions that take time. There is a need to establish a work plan for bankruptcy reform, pulling together all the elements described above, in 2019 that would play out through end-2021 and then deliver results over 2022--2024. As with reforms in all aspects of economic activity, integral to such a multi-year perspective on the reforms is the need to establish a stable leadership team. For bankruptcy, this will mean developing teams at MCA, IBBI and MoF, that will work on a sustained basis, on the bankruptcy reform.