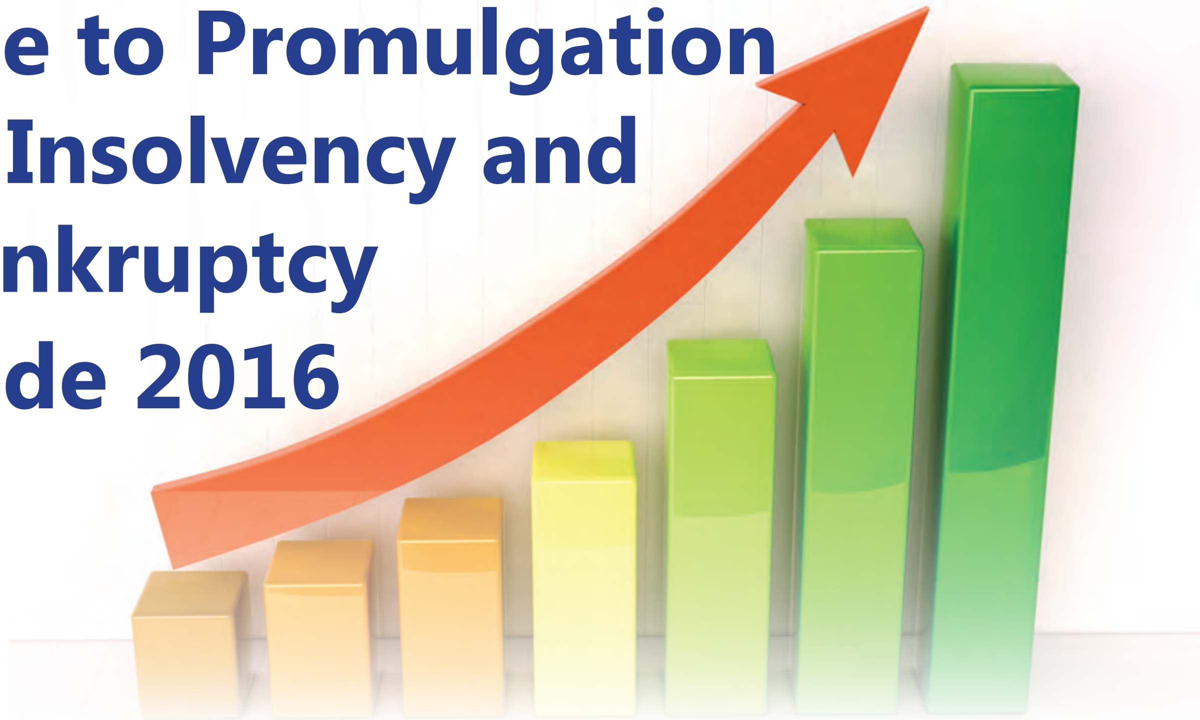
Expected Growth in Productivity in India due to Promulgation of Insolvency and Bankruptcy Code 2016



As envisaged in Bankruptcy Law Reforms Committee (BLRC) report 'India is one of the youngest republics in the world, with a high concentration of the most dynamic entrepreneurs. Yet these game changers and growth drivers are crippled by an environment that takes some of the longest times and highest costs by world standards to resolve any problems that arise while repaying dues on debt. This problem leads to grave consequences: India has some of the lowest credit compared to the size of the economy. This is a troublesome state to be in, particularly for a young emerging economy with the entrepreneurial dynamism of India. It emanates from above that the barriers to developing entrepreneurship in India is

CMA Balaknath Bhattacharyya
Insolvency Professional
Kolkata

1. Longest time as well as highest cost by world standards is involved to resolve any problems that arise while repaying dues on debt payment ,and resultant
2. Lowest credit delivery compared to the size of the economy

The reasons behind the above are as follows

Due to existence of plethora of acts and rules for recovery of debts as well as settling insolvency cases which is often contradictory in nature (At present, there are multiple contradictory elements in the legal arrangements – BLRC Report page 12) the defaulter debtor drags the cases more often than not in various courts taking resort to various acts and rules involving longer and longer time. Too much time is taken in matters of winding up also. Consequently due to illegal removal of assets of the firm by the defaulter debtor and erosion of the value of assets due to normal wear and tear the recovery rate of loan through disposal of assets becomes too low. As a result the NPA upto 2016 (Fig 1) has reached an alarming figure of about 6.97 lakh crores hich is 9.3% of total loans disbursed. As per World Bank report the average time taken in India settling insolvency is 4.3 years while in UK it is just one year and in Japan it is less than one year. Similarly the recovery rate is abysmally low of 20% only whereas it is more than 90% in UK and more than 95% in Japan (Fig 2).

Figure 1

Figure 2

HIGHEST GNPA RATIOS

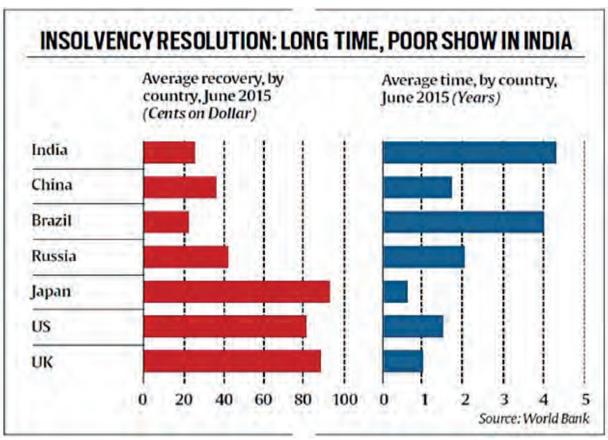
PSU Bank	GNPAratio
Indian Overseas Bank	22.42
UCO Bank	17.18
United Bank of India	15.98
IDBI Bank Ltd	15.16
Bank of Maharashtra	15.08

GROSS NPAs & ADVANCES
(Public + private)

Year	Gross NPAs*	GNPAratio
Dec '12	178,460	3.5
Dec '13	242,609	4.0
Dec '14	292,193	4.4
Dec '15	437,860	6.0
Dec '16	697,409	9.3

*In Rupees crore
Compiled by Care Ratings

Consequently in India the credit growth is not up



to the mark even it is one of the lowest in the world (Figure 3). The undue emphasis on loan against collateral also hindered the entrepreneurship culture. It deprives of various good proposals having very good prospect of fund since the entrepreneur has no or little asset to provide as collateral. As mentioned in BLRC report 'the lack of lending without collateral, and the lack of lending based on the prospects of the firm, has emphasized debt financing of asset-heavy industries. However, some of the most important industries for India's rapid growth are those which are more labour intensive. These industries have been starved of credit.' (pp-12of BLRC Report).Incidentally this would not be out of point to mention here that inspite of having collateral the recovery rate of banks and Financial institutions are not at all satisfactory which is only a paltry rate of 27% (credit growth figure)

Observation by BLRC

BLRC delved into the problem and came to the conclusion that

1. In India today creditors have been left with very little power over the company or the owner when faced with default.

2. Promoters stay in control of the company even after default. Only the banks which provided loans against collateral are able to repossess fixed assets which were pledged with them-others are left in the lurch.

3. While the existing framework for secured credit has given rights to banks for recovery of their loans, some of the most important lenders in society are not banks who have no such right to recover their dues. They are the holders of corporate bonds. They may be individuals or financial institutions. The lack of power in the hands of the bondholders to recover the investment has been one of the vital reasons for poor development of corporate bond market in India.

4. Infrastructure financing have also become a difficult proposition in India due to poor development of corporate bond market.

5. Under these circumstances the recovery rates obtained in India are among the lowest in the

world. When default takes place, lenders seem to recover only 20% of the value of debt, on an NPV basis.

6. When creditors know that they have weak rights resulting in a low recovery rate, they are averse to lend..

7. Further, undue emphasis is given on secured credit, as creditors' rights are partially present only in this case. Consequently credit analysis is relatively easy; It only requires estimating on the market value of the collateral.

8. Hence it is apparent that credit is provided preferably with the motto of recovery of the loan not with the motto of business development or for that matter for growth of economy. Hence credit analysis as a sophisticated analysis of the business prospects of a firm has been increasingly side tracked.

In View of above to control the twin devils of Indian economy - inordinate delay in resolving insolvency and poor recovery rate of loan and to achieve the following objectives GOI has promulgated the IBC 2016 in 28.05.2016 which has become operational from 01.12.2016.

1. Contributing to Economic growth of the country through being a vital part of Economic Reform Process (ranking in easy in doing business)

2. Minimizing cost to economy through maximization of the value of assets of the distressed firm as well as making all out attempts to revive the firm.

3. Development of culture of entrepreneurship through providing easy exit procedure as well as easy access to cheaper debt fund even without collateral. The debt will be granted only analyzing the business prospect.

4. Development of Corporate Bond Market providing a wide variety of debt instruments to suit different types of borrowers. there will be no dearth of cheap fund for infrastructure financing which is very crucial for economic development.

To achieve the above objectives the Code has taken the following measure which is a paradigm shift in contrast to earlier legislations.

1. Unification of all the acts rules and regulations under one code.

2. Transfer of the control of the firm to creditors from the date of initiation of insolvency resolution process – a vital difference from previous mechanism.

3. Emphasis on revival of the firm. Liquidation only if all attempts for revival fail.

4. Conducting entire resolution process in a time bound manner (180/270 days). Even all activities within the resolution process have been made time bound.

5. Fresh Start Process

The above measures mentioned will improve economy of India and make a positive contribution towards its GDP growth in the following manners.

1. **Unification of all existing Acts and rules-** It will remove confusions and contradictions through which most of the defaulters escaped. Resolution process got delayed inordinately resulting in destruction of value of assets and rendering recovery of creditors dues to lowest extent. In some cases litigation continued and continued for indefinite period. Consequently the assets of the firm including land and building remained unused, employees rendered jobless which together cost to the economy of the country very adversely. Bringing all the rules under one uniform code and under one adjudicating authority is a very effective measure to address the issue.

2. **Time bound resolution programme -** It was stated earlier that average time taken for resolution process in India is 4.2 years which is longest amongst the large economies and it is one of the vital reasons due to which the ranking of India in 'ease of doing business ' is abysmally low. The effect of this inordinate delay are

a) Decrease in lenders' confidence on debtor
b) Squeezing of debt market
c) High interest rate making a project unviable
d) Emphasis on interest against collateral
e) Discouragement of entrepreneurship. Due to very long time taken for insolvency resolution the entrepreneur cannot come out of the unviable firm and employ resources in another project. He may also lose interest in entrepreneurship. Destruction of the value of assets takes place due to natural wear and tear which is detrimental to interests of both entrepreneur and lender.

Time bound resolution programme saves time and cost of resolution as well as fetch maximum value of the assets of the firm which will enable creditor to recover his dues to the maximum extent available and enable the entrepreneur to have maximum residual value of assets so that he can invest it in another venture. This will revive the debt market by increasing confidence of the lenders.

3. **Preserving the Value of Business -** It is affected through handing over the control of the distressed firm to Creditors' Committee who will manage the firm through Insolvency Professional. This mechanism is a paradigm shift and in line with the international norm for insolvency resolution. Immediate shift of control from corporate debtor to creditor will prevent the debtor from stripping of the assets of the distressed firm which is a common practice in Indian industrial scenario. Moreover the moratorium to be declared from the date of commencement of insolvency and extended up to the date of completion of resolution will put a bar to all type of creditors secured or unsecured to claim for their dues to realize due by disposing off the collateral. A lessor cannot also take possession of the leased assets. These provisions have been made aiming at
a) fetching better value for the firm from the potential investors
b) Managing the recovery of dues of creditors in a better way since a revived and running firm has better capability to serve the debt than a liquidated firm.
C) Strengthening confidence of creditors through enabling them getting control over the firm and its assets which in turn help flourish debt market.

4. **Emphasis on revival of the firm -** It is vital shift from earlier schemes where recovery of dues f of the creditors was main objective. The foremost duty of the insolvency professional is to strive for revival of the firm. Right from protecting the assets, running the firm in a professional manner as a going concern and preparation of an effective information memorandum etc are all aimed at having good resolution plan from the competent investors for revival of the firm. IP has also the responsibility to convince the creditors committee to accept a good resolution plan which not only benefit them by providing better debt service but also help economy of the country grow. Revival of the firm cost lesser to economy by contributing to its growth as well as rescuing the job of people. Liquidation is resorted to as a last option when every attempt for survival fails.

5. **Reduction in NPA –** NPA is a normal outcome of weak insolvency regime. A stronger insolvency regime as experienced in other countries is sure to reduce NPA rate thereby enabling Banks to extend more and more cheaper loans to firms which in turn will contribute to growth of the country. As per a report (The Economic Times 24th august 2017) bad loan resolution through the Insolvency and Bankruptcy Code (IBC) can help accelerate bank credit growth which is abysmally low for the past many quarters and in the year to March 2017, bank credit growth reached a multi-decadal low of 5.08 per cent. For instance in China when such a code was implemented in 2006, bank credit grew by around 30 per cent in the third year (2009) of its implementation. And in Germany loans jumped 10 times soon after the implementation of Bankruptcy code. Similar trends were visible in Poland and Spain.

6. **Corporate bond market development -** As observed by BLRC the natural financing strategy in all countries is for large companies (e.g. the top 500 firms) to obtain all their debt financing from the bond market. This channel has been choked off in India, partly owing to the fact that corporate bond holders obtain particularly bad recovery rates under the present arrangements. Bankruptcy reform would yield higher recovery rates for corporate bond holders, and remove one barrier that impedes the corporate bond market.

Since recovery rate will improve the interest rate will also be lower thereby increasing the viability of the firms.

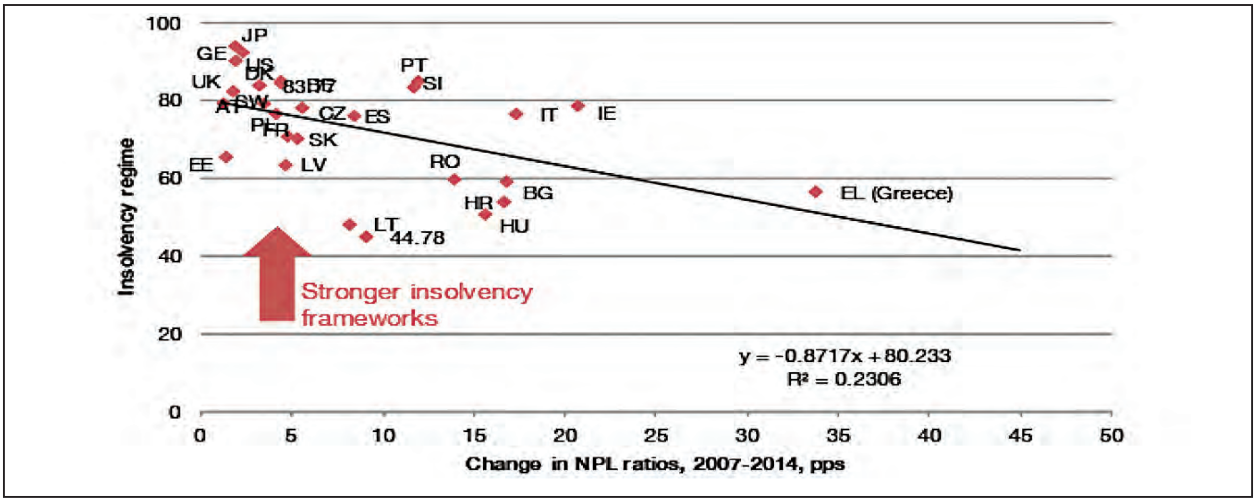
7. **Fresh Start Process -** The "fresh start" process can also foster productivity growth via better incentives for entrepreneurship and experimentation by: i) increasing firm entry ii) providing failed entrepreneurs with a second chance to apply their experience and lessons learnt to ensure their new businesses grow iii) attracting better quality entrepreneurs – i.e. individuals with higher expertise and knowledge.

International experience on effects of strong insolvency regimes

The IMF (2015) found that countries with better insolvency frameworks deleveraged faster during the post-crisis period. Also, countries with sound insolvency frameworks were able to adjust their non-performing loan ratios more rapidly than countries with weaker regimes (see Figure 3 and EC 2015).

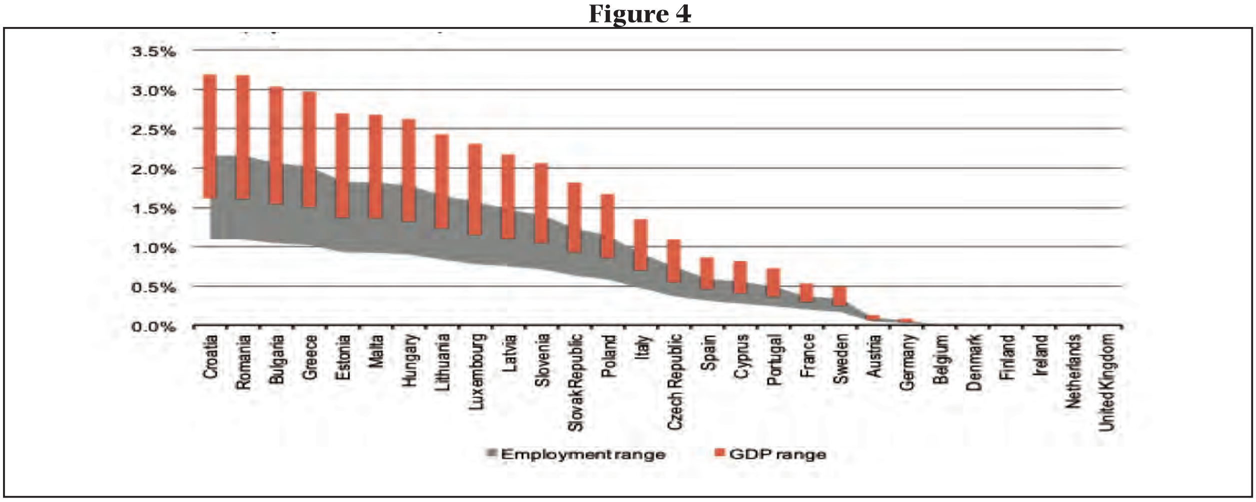
Quality of insolvency regimes in 2015 (distance to frontier) and change in NPLs (Non Performing Loans) in Europe, Japan, and the US **(Figure -3.)**

Figure 3



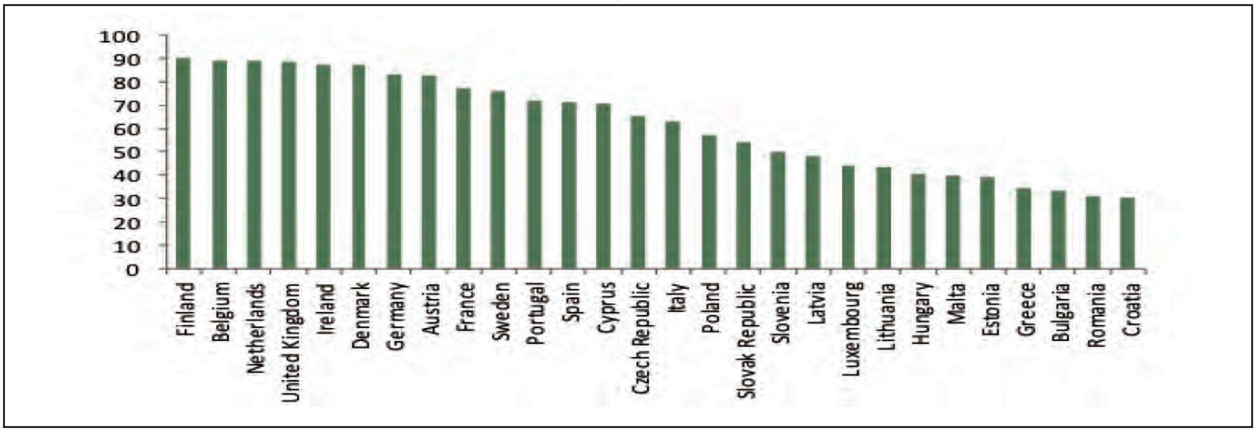
IMF also studied the impact of Insolvency regime on employment and GDP. It has found that while 0.33 parentage point to a little above 2 percentage points increased amongst the EU countries due to insolvency regime increase in employment potential is upto 3.25 percentage (Fig 4).

Figure 4



It has also been observed by IMF that debt recovery rate has been increased substantially considering the strength of insolvency which is more than 80% for about 10 countries. This enabled the banks of the concerned EU countries to release more and more fund to industries resulting in entrepreneurship and consequent growth of economy. (Figure 5)

Figure 5



NPA is a normal outcome of weak insolvency regime. A stronger insolvency regime as experienced in other countries is sure to reduce NPA rate thereby enabling Banks to extend more and more cheaper loans to firms which in turn will contribute to growth of the country.

Conclusion

Introduction of IBC 2016 is a milestone in the economic reform process with various objectives – decreasing staggering NPAs, increasing rate of recovery of outstanding dues , strengthening banks, establishing vibrant corporate bond market, encouraging entrepreneurship, lowering of lending rate , settling resolution of insolvency in a time bound matter , providing easy exit route from unviable units and releasing capital tied to the unviable units to be invested in viable project, giving honest entrepreneur a second chance, encouraging employment etc all of which has the ability for positive contribution to growth of GDP of the country as experienced in other countries as shown above. It has been estimated that IBC 2016 will along with other reform measures like GST , RERA 2016 will increase GDP of India about 2 percentage points . It will also contribute towards realizing India's dream of 80 -notch jump (The Economic Times ,dated July 3 2017) in the World Bank's ease of doing business ranking which is presently 130th out of 185 countries.. MA

References

1. *BLRC Report 2015*
2. *The importance of better EU insolvency regimes by Paul McGhee, Julio Suarez, Gary Simmons 29 April 2016*
3. *Insolvency Regimes And Productivity Growth: A Framework for Analysis Economics Department Working Papers No. 1309 By Müge Adalet Mcgowan and Dan Andrews*
4. *AFMA Reports on ECB Financial Integration Conference 2016: High-level Policy Panel II 25 April 2016*
5. *World Bank data on ease doing business*

bhattacharyyabn@yahoo.com