Fortifying the insolvency resolution framework

The Indian banking system is struggling with a deluge of bad debt. At the end of the last financial year, total stressed assets—including non-performing and restructured assets—were estimated to be at over 12% of advances. In June, the Reserve Bank of India directed banks to start proceedings under the Insolvency and Bankruptcy Code (IBC) in 12 large accounts. As reported by this newspaper, the banking regulator has also asked banks to initiate the insolvency procedure in another set of at least 28 accounts if they don't get resolved in the given time frame.

The implementation of the IBC has been one of the most important reforms in recent years. Banks and other creditors can now take the defaulting company to the National Company Law Tribunal to initiate insolvency proceedings. There is now a real chance that promoters can lose control and are no longer in a position to take creditors for a ride. Last week, in order to further strengthen the framework, the Insolvency and Bankruptcy Board of India amended the corporate insolvency resolution process. The resolution plan will now have details, such as whether the applicant or other connected persons have been convicted for any offence in the preceding five years; or have been disqualified to act as a director under the Companies Act, 2013; or have had any transactions with the debtor in the preceding two years. The revision in regulation now makes "it incumbent upon the resolution professional to ensure that the resolution plan presented to the committee of creditors contains relevant details to assess the credibility of the resolution applicants".

The basic idea is that with more information about resolution applicants at their disposal, the committee of creditors will be better placed to take a more prudent decision. However, the amendments are likely to make it more difficult for promoters to regain control. For example, among the ongoing cases, Essar Group is reported to have submitted an expression of interest for Essar Steel. Since the scope of evaluation has been broadened and, among other things, the committee of creditors will now also explicitly look at the credibility and creditworthiness of applicants, the fact that existing promoters were in command when the company defaulted is likely to work against them.

It is often observed that deterioration in company finances doesn't necessarily affect the promoter's financial well-being. Therefore, it is possible that in order to regain control, promoters would be willing to put funds on the table in return for a significant reduction in debt. But this will now become difficult. Differently put, going by the regulatory design, promoters would not be in a position to game the system any more. Lenders may not be willing to hand the company back to the same promoters who could not manage the business in the first place. This is not to suggest that all promoters work with ill intentions or are inefficient. It is possible that a company landed in financial difficulty because of regulatory issues or an unforeseeable change in the business environment. While the changes are likely to make the insolvency resolution process more robust and transparent, they would increase the pressure on the resolution professional as the entire process is time bound.

However, overall efficiency of outcomes will also depend on how freely bankers in the public sector are able to take decisions. One of the reasons why they have not been able to address the issue of bad debt in a meaningful way till now is because of the fear of investigative agencies in case of a large haircut. Although it looks unlikely that they will face similar problems under the insolvency process as the resolution plan will be approved by a committee of creditors and accepted by the adjudicating authority, it still remains to be seen if public sector bankers will be confident enough to take bold decisions.

Overall, the changes will make the insolvency resolution process more robust and make things difficult for unscrupulous promoters. At a broader level, while the IBC will now be addressing the resolution part of stressed assets, and efforts are being made to strengthen the framework, Indian policymakers now also have an opportunity to work towards minimizing the origin of bad loans. The government is working on a massive Rs2.11 trillion bank recapitalization plan. It will be important that capital find a way to more efficient banks and be accompanied by structural reforms. Reckless lending by banks was one of the significant reasons for the accumulation of bad debt in the system. Public sector banks should have the capability to properly evaluate risks in lending to a particular company. This will reduce pressure on the system at the aggregate level.

Better lending standards and a robust mechanism to address insolvency will lead to better allocation of capital and help augment growth in the medium to long run.

Will improvement in the insolvency resolution framework lead to better allocation of capital? Tell us at views@livemint.com

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