

Evaluating the IBC and the way forward



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If all borrowers show discipline when servicing their debt there would be no problem for lenders. But this is not the case. If one keeps aside cases where there is willful default, companies may not be able to repay because business conditions are hostile. Or it is just a case of their models failing leading to build up of losses which makes it hard to service debt. How should such cases be settled?

The RBI has already in place the concept of non-performing asset where there are dues for over 90 days. To ensure there is proper tracking of the same there are special mention accounts categorization that is reported so that a bank can see how the quality of assets is moving so that there can be preemptive action taken. It is only when the asset becomes a NPA that a resolution plan has to be sought. This is where the IBC comes in, which has been probably the most significant development in the financial sector in the last decade as it got implemented from roughly 2016-17.

The IBC simply says that once the asset is recognized to be non-performing, the creditors need to work out a resolution plan with the debtor in the next 180 days with another 90 days extension being provided. After that the case qualifies for insolvency proceedings which means that the asset can be technically sold and the proceeds distributed to the creditors.

There have been two issues here along the way. The first is the availability of professionals to handle the resolution part of the story. There is also the case of the companies dragging their feet and seeking legal redress to delay the proceedings. This is but natural and economics would bring in the classic tenets of game theory where both sides play their cards. Banks too may like to keep the case going so that they do not have to accept lower recovery rates and hope for a resolution plan to work out. Therefore there may be a perverse incentive to maintain the status quo which elongates the entire process. In fact, one reason why the concept of asset reconstruction did not quite take off was that the seller wanted the highest valuation and the buyer the lowest. An equilibrium price was hard to arrive at.

The other issue has been more philosophical. In February 2018, the RBI had come out with a now rather epochal notification which made it mandatory for all cases to go to the NCLT after the stipulated time period which caused umbrage. Promoters could lose ownership which would come in the way of enterprise. It was argued that all business carries risk and if business environment turns perverse, snatching the asset away was not fair. Sectors like power or steel would always have such challenges. Therefore there was an outcry. The government also argued in their favour and put forth the view that while RBI could ask for specific cases to be sent to the NCLT for liquidation, it did not have power to do so on a generalized basis. The Courts supported this view and the notification was withdrawn.

The RBI then came up with a revised notification in June 2019 which changed the rules of the game. Simply put, it said that once these deadlines were overstepped, the banks had to make additional provision for capital which kept increasing with the age of the non-performing asset. Hence the onus was passed on the banks which had to either push the company to NCLT or make the requisite provisions. This background is important when evaluating the efficacy of the IBC.

The IBC started with fanfare with 12 big accounts being identified for action. There have been so far 6567 CIRPs (corporate insolvency resolution process) admitted until March 2023 involving Rs 8.99 lakh crore. Of these 4515 have been closed. Of them 2485 were rescued, 959 closed on appeal or settled, 848 withdrawn and 677 have had resolution plans approved. 2030 have ended in liquidation while 2053 are ongoing. The realization of creditors as % of their claims was 31.8%. The average time for resolution of a CIRP was 456 days.

Cumulative as of March	Total CIRPs initiated	Realization ratio
2019	1800	43.0
2020	3774	45.96
2021	4376	39.26
2022	5258	32.89
2023	6567	31.8

Source: IBBI

The reason for the declining realization or recovery is that with the passage of time there is depreciation in value of the asset. Also, when being sold there could be delays before a buyer can be found. A steel mill which is non-operational for long will no longer be efficient and hence the value comes down. This is why the recovery rates have been coming down over time. Hence as the low hanging fruits are plucked, it gets progressively difficult to reach out successfully to the higher ones which results in lower realizations.

The table below gives the relative performance of the IBC in terms of recovery compared with other modes of NPA resolution that have been in existence for a longer period of time.

NPA recovery through different channels

March	Lok Adalat	DRT	SARFAESI	IBC	Total
2018	4.0	5.4	24.8	49.6	13.7
2019	5.1	3.9	15.0	45.7	16.3
2020	6.2	4.1	26.7	45.5	23.2
2021	4.0	3.6	41.0	20.2	14.0
2022	2.3	25.7	22.5	23.8	18.4

Source: RBI

The IBC was the avenue used for NPA resolution in around 32% of total amount involved in FY20 when the recovery rate was higher at 45.5%. In FY22 the cases resolved through IBC was 41% of total. Quite clearly this was being progressively preferred by both the parties concerned. Using asset reconstruction companies was the second most preferred route where the recovery rates have tended to be more aligned with that with the IBC.

The IBC can be looked at more like a market solution to a problem on non performing companies. There is a binary approach used. A resolution process works out mutually beneficial to the borrower and lender during the 180 days period that has been offered by the IBC. Therefore, companies which are viable in the medium term but facing temporary challenges do end up with reorganization and restructuring where the banks will also be partner. The resolution plan could involve more finance, change in tenure of loans which are extended and probably negotiated interest rates. The company would have to, in turn, bring about certain changes in operations and go in for deeper structural changes. Alternatively in case this is not possible, then there is a case of liquidation.

The essence is really one of timing, as time bound resolution either way is the clue to the success of any process. This is the area where there is scope for improvement both in terms of having more experts in the group given the number of cases involved. Both sides evidently have to get in the necessary compromises for timely resolution of such processes. There has to be a realistic and pragmatic approach taken as evidently an Rs 100 of non-performing asset cannot get the same value in the market given the factors that led to this eventuality. A timely resolution, which may not be the best for the bank also helps them to focus better on their core business and not get bogged down by the process.

From the point of view of the debtor the IBC has helped insofar that there has been a change in the behaviour of companies. This is important because the threat of possible loss of ownership and control ensures there is more compliance. Accordingly there is more effort put in to service debt which helps to improve relations with the banks.

The recent notification of the RBI to allow for compromise settlements is a good step. Banks can now work out a solution with the debtor and invoke a write-off from their books in return for payment of cash by the party. This however will be ring fenced by systems that have been specified by the RBI to ensure that the Board passes the criteria that will be used to determine the value. The advantage in such compromise settlements is that it cuts down on the resolution time and will be resorted to in extreme conditions where both sides are convinced that it is the best way out.

Strengthening the efficacy of the IBC is very important from the point of view of future of the financial system. What is required is a swift way to resolve the issue of NPAs where time is of essence. This is so as the value to be derived from asset sale would get maximized. While the IBC has been seen as a remedy for a banking problem it should be realized that it has ramifications for the financial system as a whole. In particular it is relevant when it comes to evolving the corporate debt market.

When we speak of the corporate debt market, one of the lacuna is the absence of a system of recovery. This is one reason as to why it has remained mainly a market for institutions. When there is a default, the only way out is to go through the judicial processes which are time consuming. Also one can never be sure of the result as these bonds tend to be unsecured. There is a lot of emphasis put by the regulators on getting in the retail investors in this market. The major factor holding back this class of investors is the absence of a redressal system. A successful IBC will instill confidence in the market and efforts can be made by the regulator to also extend the circumference of its domain to corporate debt.

For this to happen the IBC has to be able to prove its efficacy which will not just be in terms of the recovery rate which in turn is contingent on other factors such as the time lines involved as well the availability of experienced professionals. Therefore, the focus from hereon has to be on making the IBC more robust so that the time lines are adhered to and that the time taken to resolve an insolvency case is minimal. In fact, the IBC can then be extended to the bond market too with the time lines being further shortened. In case of the banking system an asset becomes a NPA after 90 days whereas in case of a bond a single day default makes it a defaulter where rating agencies lower the same to 'D' grade.

As future growth of the economy will be predicated on strong investment growth, it would require a considerable amount of funds to flow in. Banks may not be in a position to supply the same and hence the markets as well as the new DFI established will have a larger role to play. For this to work out the IBC has to work well as it will also send useful and powerful signals to foreign investors who are waiting to invest in India but are still not sure of the strength of the bankruptcy and insolvency resolution systems in the country.