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Insolvency and Bankruptcy Code: The Emerging Landscape for Resolution of Stressed Assets in Indian Banking

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Abstract

The Insolvency and Bankruptcy Code marks a break from the past. The new code for resolution of stressed assets is designed to streamline corporate insolvency resolution process in a completely new manner. It is designed to prevent value destruction in cases of corporate distress. The resolution process is a representative action for the general body of creditors instead of recovery of money for just an individual creditor. Being a time bound process to resolve cases within 180 days extendable to 270 days; the IBC has received praise and attention from multilateral agencies as well as from foreign investors. The enthusiastic response and dynamic activity in terms of number of applications filed for resolution, their positive outcome and quantum of NPAs to be resolved has brought Insolvency and Bankruptcy Code in the forefront. We have attempted to capture the key regulations and processes with regards to resolution of NPAs and emergence of Insolvency and Bankruptcy Code and its performance in this short period of time. The Insolvency and Bankruptcy Code has brought about a paradigm shift in the resolution of Indian banking sector

Keywords: Insolvency and Bankruptcy Code, NPA, Stressed Assets

Introduction:

Non-performing Assets (NPA) are those loans and advances extended by banks which no longer generate income through interest earned on the principal loan amount and the repayment of the principal loan amount. Non-Performing assets usually arise for two reasons: In the first case, the borrower intentionally defaults on the loan payment. In the other case borrower is unable to repay the loan due to poor performance of his business. In both cases, it means that the loan asset may not be fully recovered, or if recovered, only partly. Banks are in the business of transforming deposits into loans and recovering those loans, non-performing assets reflect a bank's overall efficiency while performing its business. Non-recovery or partial recovery of loans has a direct impact on the bank's balance sheet and income statement. It reduces interest earned on loan assets, increase in provision on NPAs, increase in capital requirement and lower profits. Hence, NPAs has always been a cause for concern for the banking sector.

Between early 2000's and 2008 it was a boom phase for the Indian economy. During this period, banks especially public sector banks lent extensively to corporates. However, the profits of the

corporates dwindled due to slowdown in the global economy, delay in environmental approvals and ban on mining projects. Power, iron and steel sectors were primarily affected by the slowdown. It increased the raw material price volatility. This in turn negatively impacted the ability of these companies to pay back their loans and is one of the important reasons behind increase in Non-Performing Assets (NPA) in India.

Non-performing Assets (NPAs) at the commercial banks in India stood at Rs. 10.30 trillion, or 11.2 % of advances in March 2018. Public Sector Banks accounted for Rs. 8.9 trillion. In other words it was 86 % of total NPAs. The ratio of gross NPA to Advances in PSBs was 14.6%. These are levels typically refer to a banking crisis. In 2007-08, NPAs totalled Rs. 566 billion, a little over half a trillion, or 2.26 % of gross advances. The increase in NPAs since then has been huge.

Public sector banks are largely responsible for the NPA problem in India. The State Bank of India (SBI) group's gross non-performing assets (GNPA) stood at 5.17% .Other public sector banks' GNPA stood at 4.13% in 2014. World GNPA to gross loans was at 4.3% in 2015. Although Indian GNPA is lower than the world figure, NPA in Indian banks is on the rise and is higher than emerging nations such as China, Mexico and Brazil that have a GNPA of 1.5%, 2.5% and 3.3% respectively in 2015. Their GNPA is lower when compared to Indian banks.
The rise in NPAs in Indian banks is also owing to the new RBI guidelines. RBI tried to curb the banks' malpractice to defer bad loan recognition. The fresh RBI guidelines recognized restructured assets on par with non-performing assets. Further, restructured assets attracted a provision similar to NPAs by 2016. These new guidelines have impacted the non-performing assets numbers and bank earnings.

A numbers of measures have been taken in the past to address resolution of the NPAs. In the past, the insolvency resolution process involved simultaneous operation of several statutory instruments. These include the Sick Industrial Companies Act-1985, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act-2002, the Recovery of Debt due to Banks and Financial Institutions Act- 1993, and the Companies Act- 2013. Generally, these legal frameworks provided for disparate processes of debt restructuring, asset seizure and realization in order to ensure the satisfaction of outstanding debts. Evidently, a plethora of legislation dealing with NPAs led to increased confusion in the legal system. There was a serious need to overhaul the insolvency regime. All of these multiple legal avenues, and a slow justice system led to our country witnessing a huge piling up of non-performing assets. Creditors waited for years to recover their money.

The Insolvency and Bankruptcy Code, 2016 ('IBC') is a sincere effort at a comprehensive reform of the fragmented regime of corporate insolvency framework. This legal framework aims to allow credit to flow more freely in India and instilling faith in creditors for speedy disposal of their claims. The Code consolidates existing laws relating to insolvency of corporate entities and individuals into a single legislation.

I. Literature Review

NPAs have always remained an important topic for researchers. Many academicians in past have examined NPA determinants. Academicians such as Berger and DeYoung (1997), Podpiera and Weill (2008), Li et al. (2007) and Breuer (2006) investigated determinants of NPAs. They focussed on a bank's efficiency. They studied a bank's efficiency using a number of bank operational ratios such as operational costs in relation to interest income, net interest income to total assets etc. Their studies found empirical evidence that lower efficiency and NPAs have a positive relation. Later, academicians such as Salas and Saurina (2002), Sinkey and Greenawalt (1991), Clair (1992), Hess et al. (2009), Borio et al. (2001) and Keeton (1999) studied loan growth and its effect on non-performing assets, and found empirical evidence that higher loan growth leads to higher NPAs. These studies revealed when a bank undertakes aggressive loan growth it tends to overlook the credit risk undertaken. These loans may turn into NPAs in the future. A few other studies such as ones conducted by Bhatia, Mahajan and Chander, 2012 suggested that bank profitability affected NPAs. These studies found that NPAs and bank profitability bear a negative relationship. A bank's capital, solvency and liquidity also affect the extent of NPAs. These determinants were considered as well by researchers. Academicians such as Gonzalez-Hermosillo et al. (1997) and Louiz et al. (2012) contend that well-capitalised banks tend to have lesser NPAs as the bank tends to keep credit risk levels at a low while lending to borrowers.

Researchers such as Berger and DeYoung, 1997; Drake and Hall, 2003; Podpiera and Weill, 2008; Li et al., 2007 and Breuer, 2006 studied the efficiency in bank management. They suggest Bank efficiency represent the ability of the bank management to align bank processes to ensure smooth credit generation. This is possible using manpower and technology resources according to the bank's vision. Certain studies found empirical evidence that a negative relationship exist between efficiency and NPAs. These studies were made by Barr and Siems,1997; Martin, 1977; Hanweck, 1977; Pantalone and Platt, 1987; Karim, Chan and Hassan, 2010; Kwan, 2006. Subsequently, researchers started exploring how loan growth affected NPAs. They found that banks with a high loan growth rate had higher NPAs. Loan growth represented a bank's business development capacity. These studies suggested that banks that followed an aggressive loan growth often overlooked the credit risk undertaken while lending. Hence high loan growth resulted in higher

NPAs. Salas and Saurina, 2002; Sinkey and Greenawalt, 1991; Clair, 1992; Hess et al., 2009; Borie et al., 2001; Keeton, 1999 conducted important studies.

The paper is divided into six parts. Part I is the introduction. Part II gives an account of literature review related to various aspects of NPA, Part III details the measures introduced prior to IBC for resolution of NPAs, Part IV discusses the IBC, in part V we give a brief account of comparative performance of IBC to be followed by conclusions in part VI.

II. Legal Frameworks before IBC :

The bad loan recovery mechanism was governed by the following legislations prior to the enactment of Insolvency and Bankruptcy Code, 2016 (IBC)

A. The Presidency Towns Insolvency Act, 1909 and The Provincial Insolvency Act, 1920 : The Presidency Towns Insolvency Act, 1909 (PTSI) was enacted on March 12, 1909. It was enforced on January 01, 1910. The Act covered insolvency of individuals, partnerships and associations of individuals. The jurisdiction of the Act was in the erstwhile presidency towns of Chennai, Kolkata and Mumbai.

-The Provincial Insolvency Act, 1920 (PSI) was enacted on February 25, 1920. The Act laid down insolvency laws for individuals, partnerships and associations of individuals in India except for the presidency towns mentioned above.

-The two enactments dealt with personal insolvency. They had parallel provisions and their content is substantially similar. However, the two differed in respect of their territorial jurisdiction as specified above.

B. Companies Act, 2013: The Companies Act, 2013 (Act) provides for a comprehensive guidance for insolvency of companies through the following:

- Revival and Rehabilitation of Companies - Chapter XIX of the Companies Act, 2013

- Liquidation of Companies – Chapter XX of the Companies Act, 2013

- While the provisions relating to revival and rehabilitation of companies stand omitted, provisions relating to liquidation of companies came into effect from December 15, 2016.

- The legislation provides for liquidation of companies when a company is not able to pay off its debts outstanding to its creditors including winding up of a company by the National Company Law Tribunal (NCLT).

C. The Recovery of Debts due to Banks and Financial Institutions Act, 1993: As at September 30, 1990 numerous cases were pending in various courts amounting to Rs.6000 crores in dues of Public Sector Banks and financial institutions.

The existing frameworks for recovery of debts due to the banks and financial institutions had blocked a significant portion of funds in unproductive assets, the value of which deteriorated over time.

Hence, the Recovery of Debts due to Banks and Financial Institutions Act, 1993 was enacted to provide for the establishment of Debt Recovery Tribunal (DRT) and Appellate Tribunals (AT) for expeditious adjudication and recovery of debts due to banks and financial institutions.

D. The Sick Industrial Companies (Special Provisions) Act, (SICA) 1985 :

-SICA applied only to industrial units specified in the First Schedule of Industries (Development & Regulation) Act, 1951 subject to exemptions specified in the Act. The provision covered only specific set of Industrial units. Government companies having State or Central Government share holdings of 51% or more were kept outside the purview of SICA. Also small scale industrial units and ancillary units were kept outside the purview of SICA.

-SICA applied only to those industrial units which were in existence for more than 5 years and had accumulated losses equal to or greater than their net worth. SICA provisions could not be applied at an early stage of sickness.

- Ensuring a time bound resolution process under SICA was difficult to achieve. Significant time taken by BIFR to admit an application under SICA for further investigation.

-An essential part of SICA was that while the scheme was being prepared and approved, there was a moratorium on taking any legal action against the company for recovery of debts, enforcement of security, winding up, etc. Unfortunately, companies ended up staying within the protection of the SICA moratorium for years without any successful scheme for rehabilitation

-BIFR and High Courts were reluctant in liquidating a sick company due to fear of loss of jobs, labour unrest, etc.

-In case of winding up of a company, SICA did not provide for any mechanism for distribution of assets of the company. The same was then governed

SARFAESI Act, 2002: The 'Recovery of Debts due to Banks and Financial institutions Act, 1993 had several loopholes which were misused by the borrower. To address these issues, the Government enacted the 'Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002' ('SARFAESI').

SARFAESI provides financial institutions a mechanism to make recoveries in their NPAs without the intervention of the court as long as the NPAs are backed by securities charged to the bank by way of hypothecation or mortgage or assignment. If the asset in question is an unsecured asset, the bank would have to move to court to file a civil case against the defaulters

Securitization: It is the process of issuing marketable securities backed by a pool of existing assets such as auto or home loans. The process involves converting a financial asset into a marketable security for the purpose of selling it. A securitization company ('SC') forms a scheme for acquiring financial assets and raises funds from Qualified Institutional Buyers ('QIB') for this purpose. The SC issues a security receipt to the investors for the funds raised, which may thereafter be traded by the investor

Asset Reconstruction: The bank bundles a few NPAs and sells them off to an Asset Reconstruction Company ('ARC') at a discount. The ARC may then take over or change the management of the borrower, sell or lease off part or whole of the borrower's business, reschedule the debts repayment schedule of the borrower and/ or enforce the security interest in accordance with the provisions of SARFAESI

III. The Insolvency and Bankruptcy Code, 2016 ('IBC')

The Insolvency and Bankruptcy Code, 2016 ('IBC') is the newly enacted bankruptcy law of India. It seeks to consolidate the existing framework for debt recovery by creating a single law for insolvency and bankruptcy. The Insolvency and Bankruptcy Code, 2015 was introduced in Lok Sabha in December 2015. It was passed by Lok Sabha on May 5, 2016. It received the assent of the President of India on May 28, 2016. The Code became effective in December 2016.

It is a one stop solution for resolving insolvencies which at present is a long drawn out process and does not offer an economically viable arrangement. A strong insolvency framework where the cost and time incurred is minimized in attaining liquidation has been long overdue in India. The code strives to protect the interests of investors and make the process of doing business a less cumbersome process.

The Bankruptcy Code is an effort at a comprehensive reform of the fragmented regime of corporate insolvency framework. This is in order to allow credit to flow more freely in India and instilling faith in investors for speedy disposal of their claims. The Code consolidates existing laws relating to insolvency of corporate entities and individuals into a single legislation. The Code has unified the law relating to enforcement of statutory rights of creditors and it has streamlined the manner in

which a debtor company can be revived to sustain its debt without extinguishing the rights of creditors.

Framework of the Code

All proceedings under the Code in respect of corporate insolvency are to be adjudicated by the NCLT. NCLT has been designed as the special one window forum which tackles all aspects of insolvency resolution. The NCLT is referred to as the Adjudicatory Authority in relation to insolvency of corporate persons under the Code. No other court or tribunal can grant a stay against an action initiated before the NCLT. Appeals from the orders of the NCLT lie before the National Company Law Appellate Tribunal (**"NCLAT"**). All appeals from orders of the NCLAT lie to the Supreme Court of India. The jurisdiction of civil courts is explicitly ousted by the Code with regard to matters addressed by the Code. Additionally, it is now established that the Limitation Act, 1963 shall be applicable to proceedings under the Code. Thus, time-barred claims are outside the purview of insolvency. When resolution/restructuring of debts is not viable, the NCLT may direct for dissolution of the company. The Code envisages a two stage process, *first*, revival and *second*, liquidation.

A brief overview of the "Insolvency Resolution Process" is explained below.

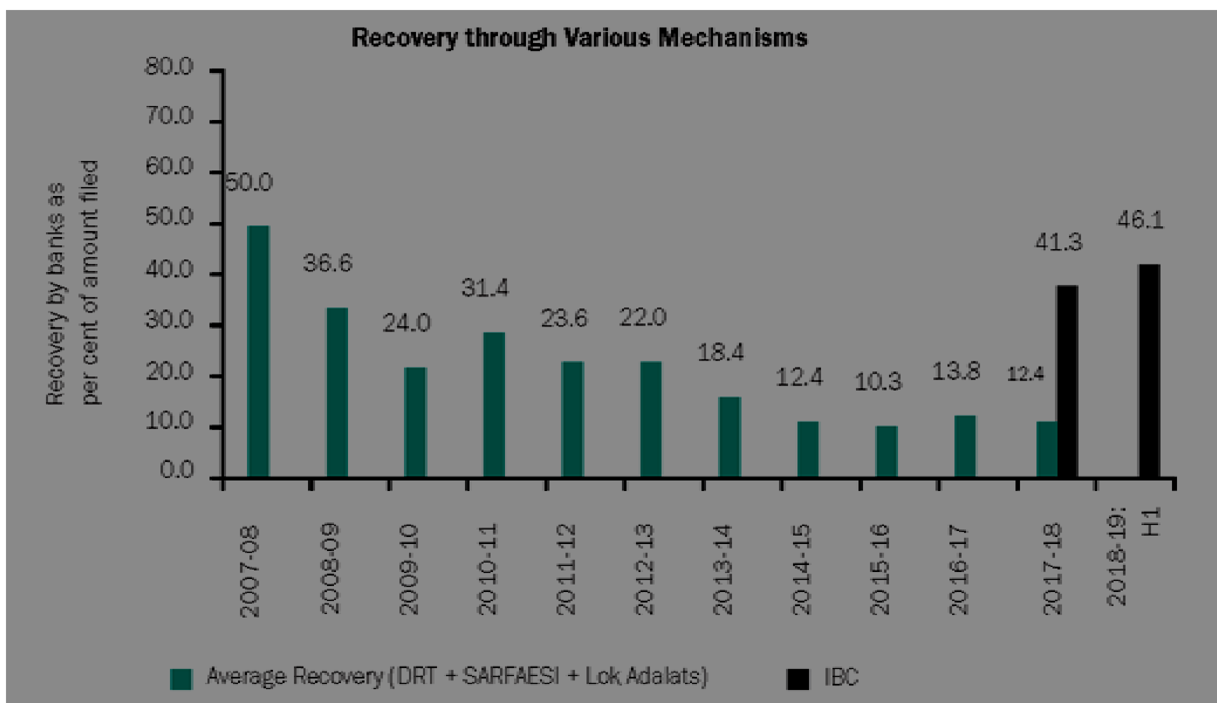
Insolvency Resolution Process

A primary objective of the enactment of the Code is to aid a debtor in resolving an insolvency situation without approaching liquidation, by finalizing an insolvency resolution plan ("**Resolution Plan**"). A properly structured Resolution Plan is supposed to provide a strategy for repayment of the debts of the debtor after an evaluation of the debtor's worth. This is to be done while allowing for the survival of the debtor as a going concern. The Resolution Plan must also provide for repayment of the debt of operational creditors. The repayment to operational creditors shall not be lesser than the amounts that would be due should the debtor be liquidated. Additionally, it should identify the manner of repayment of insolvency resolution costs, the implementation and supervision of the strategy. It is to be ensured that all this is in compliance with the law. If the terms , including the terms of repayment, under the Resolution Plan are approved by the committee of creditors, and subsequently by the NCLT, the Resolution Plan would be implemented, and the debtor may emerge from the debt crisis with a fresh chance for business and reduced liabilities.

IV. Performance of IBC

Non-performing Assets (NPAs) at the commercial banks in India stood at Rs. 10.30 trillion, or 11.2 % of advances in March 2018. Public Sector Banks accounted for Rs. 8.9 trillion, or in percentage terms 86 % of total NPAs. The ratio of gross NPA to Advances in PSBs was 14.6%. In 2007-08, NPAs totalled Rs. 566 billion or 2.26 % of gross advances. The increase in NPAs since then has been staggering and can be termed as a banking crisis.

A report by the Reserve Bank of India on the progress and trends of banking in India 2017-18 shows an insightful comparison on the efficacy of the IBC in improving the recovery rate and in providing the lenders with a superior realization in comparison to the prior regimes of recovery.



Source : RBI Report 2018-19

The above shows that the IBC is just an evolving legislation. However, it has shown impressive results in 2 years, especially in comparison to the prior recovery and distress resolution regimes. The realization amount under the corporate resolution framework of the IBC has also proven to be higher in comparison to the realization value under the previous regimes. The graph depicted above shows that the recovery in percentage terms under the previous regimes for the year 2017-18 was 12.4 % approx. while it has been at approx. 41.3% under the Code.

The Code has enforced a significantly better sense of credit discipline. There is a sense of urgency and seriousness among defaulting borrowers. Fear of losing their asset is very much a possibility if the resolution process fails. Almost Rs. 2.02 lakh crore to Rs. 3 lakh crore of debt pertaining to

4452 cases was disposed of even before admission into the IBC process, as the borrowers made good the amounts in default to creditors.

V. Conclusion

IBC has brought about a paradigm shift in the resolution framework of stressed assets in the banking sector. It has altered the balance of power from the side of the borrowers to the creditors. Within three years of being legislated, the IBC has made measurable progress in addressing the backlog of stressed assets. It has expedited the recovery of stressed assets with faster resolution process.

IBC is a time bound process to resolve cases within 180 days ; extendable to 270 days. As a result IBC has received praise from the World Bank and IMF. Further it has materially contributed to India’s improved ranking in 2018’s ‘ease of doing business’ by 30 places. The Code has undoubtedly grabbed significant attention from foreign investors.

However, certain issues such as the proposed eligibility criteria for bidders have rendered it less effective. It has compromised its capacity to help creditors efficiently. The strict time line for the resolution process under IBC, is an area that has also drawn much attention. It merits further review in order to balance the twin objectives of maximising recovery of lenders along with speedy resolution.

However, the enthusiastic response is clearly reflected in terms of number of applications filed for resolution, their outcome and quantum of NPAs to be resolved. Now, IBC is in the forefront of as a framework to resolve stressed assets.

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