

## TOWARDS A SUCCESSFUL INSOLVENCY AND BANKRUPTCY CODE

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The enactment of Insolvency and Bankruptcy Code in India is a culmination of 60 years and is perhaps one of the best reforms in the financial market. Till the year 1985, the legal framework for dealing with corporate insolvency and bankruptcy in India consisted of only one law - The Companies Act, 1956. This was followed by The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDBI) under which DRTs were established. Finally, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) was enacted in 2002. Around the same time when SARFAESI Act was introduced, Reserve Bank of India introduced a Corporate Debt Restructuring Scheme.

**The IBC has met with much success in its short period of 3 years.** The success rate of companies under several regulations pre-2016 was abysmally low and varied from 16% to a maximum of 25%. In contrast, the success rate of companies under IBC in terms of closure is already at 41% and increasing! The recovery rate is 43%, up from 12% in FY15 through other mechanisms with defaulting promoters losing control of the company.

However, the working of the IBC could be made even more successful through some tweaks.

**Firstly, out of 2542 cases admitted, around 1232 cases i.e. 48% are initiated by operational creditors,** while financial creditors initiated around 43% i.e. 1086 cases and remaining 9% were initiated by corporate debtors. Given very small threshold limit of Rs 1 lakh, operational creditors seem to be more aggressive in dragging the Corporate Debtor into NCLT, eating the bandwidth of the courts and thereby delaying resolution of the bigger cases. Additionally, recovery through Lok Adalats and DRTs has declined significantly post FY16 alongside the number of cases referred, partly indicative of growing clout of the IBC mechanism for resolution of stressed assets. **It seems even small creditors are preferring IBC rather than SARFAESI, DRT etc. and using the platform more as a recovery tool. This must be avoided. For such Government should first significantly increase the minimum threshold limit of Rs 1 lakh and second, increase the number of NCLT benches in the country.**

**Secondly, it is also observed that more than 23% of the admitted companies ended with liquidation.** One way of looking into this is, at the time of lower demand and economic downturn there are not many takers of the stressed assets and hence entities ended with liquidation. It is in this context, sectors such as Construction, EPC, Electricity etc. where there are no hard assets have also been dragged to NCLT. **Efforts should be made to find a resolution of such companies outside the NCLT if possible, as these could save resources and time for the already hard pressed NCLT benches!**

**Thirdly, for IBC to be successful in India, culture should be increasingly playing a role!** Culture plays a substantial role in Chinese laws, especially its bankruptcy laws. Same is in Japan.

**Finally, we firmly believe that the IBC could perhaps fast track the development of corporate bond market in India!**

### THE ROAD TO IBC: 60 YEARS OF CHANGES IN LAW BEGINNING 1956

- ◆ Till 1985, the legal framework for dealing with corporate insolvency and bankruptcy in India consisted of only one law - The Companies Act, 1956. Despite several sections addressing the resolution process, the original Act of 1956 was incapable of dealing with corporate insolvencies.
- ◆ In 1985, the Sick Industrial Companies Act, 1985 (SICA) was enacted. The SICA had several shortcomings, and abuse of Section 22 of SICA is often highlighted as an example of the inherent deficiency in its provisions.
- ◆ This was followed by The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDBI) under which DRTs were established. Initially the system functioned well. But as time progressed Act failed to make any improvements in the muddled insolvency landscape, primarily due to the fact that SICA had precedence over RDBI.
- ◆ Finally, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) was enacted in 2002. Around the same time when SARFAESI Act was introduced, Reserve Bank of India introduced a Corporate Debt Restructuring Scheme ("CDR Scheme") that provided broad guidelines for debt restructuring by Banks. It was thus clear by the year 2010 that a single, comprehensive framework was needed to effectively tackle delay in insolvency and bankruptcy proceedings. Thus the IBC was established!

### IBC HAS MANY SUCCESSES BUT IT MUST BE PURELY A RESOLUTION MECHANISM AND NOT A RECOVERY TOOL

- ◆ Interestingly, this 60 years of Indian experience in insolvency resolution (till IBC came into existence) suggests a similar story as in the US (the first bankruptcy law was passed on April 4, 1800 in USA).
- ◆ The success rate of companies under several regulations pre-2016 was abysmally low and varied from 16% to a maximum of 25%. In contrast, the success rate of companies under IBC in terms of a closure is already at 41% and increasing! The recovery rate is 43%, up from 12% in FY15 through other mechanisms with defaulting promoters losing control of the company.

Corporate Insolvency Resolution Process (CIRP)							
Quarter	No. of CIRPs at the beginning of the Quarter	Admitted	Closure by				No. of Corporates undergoing Resolution at the end of the Qtr.
			Appeal / Review	Withdrawal under section 12A	Approval of Resolution Plan	Commencement of Liquidation	
Q4 FY17	-	37	1	-	-	-	36
Q1 FY18	36	129	8	-	-	-	157
Q2 FY18	157	233	18	-	2	8	362
Q3 FY18	362	147	38	-	7	24	440
Q4 FY18	440	195	20	-	11	59	545
Q1 FY19	545	246	20	1	14	52	704
Q2 FY19	704	243	30	27	29	87	774
Q3 FY19	774	275	8	36	17	82	906
Q4 FY19	906	374	20	19	22	86	1133
Q1 FY20	1133	294	14	19	27	93	1274
Q2 FY20	1274	369	9	14	27	96	1497
<b>Total</b>	<b>NA</b>	<b>2542</b>	<b>186</b>	<b>116</b>	<b>156</b>	<b>587</b>	<b>1497</b>

Source: IBBI, Data compiled from details available on NCLT Website; SBI Research

Resolution Mechanism in India						
		FY15	FY16	FY17	FY18	FY19
Lok Adalats	No of Cases	29,58,313	44,56,634	35,55,678	33,17,897	
	% Recovery	3.2	4.4	6.4	3.9	
DRTs	No of Cases	22,004	24,537	32,418	29,551	
	% Recovery	7.0	9.2	10.2	5.4	
SARFAESI Act	No of Cases	1,75,355	1,73,582	1,99,352	91,330	
	% Recovery	16.3	16.5	18.3	24.8	
Total (Lok Adlats+DRTs+SARFAESI)	No of Cases	31,55,672	46,54,753	37,87,448	34,38,778	
	% Recovery	12.4	10.3	13.8	12.4	
IBC	No of Cases	-		37	701	1,138
	% Recovery	-			49.6	43.0
Grand Total	No of Cases	31,55,672	46,54,753	37,87,485	34,39,477	-
	% Recovery	12.4	10.3	13.8	41.3	

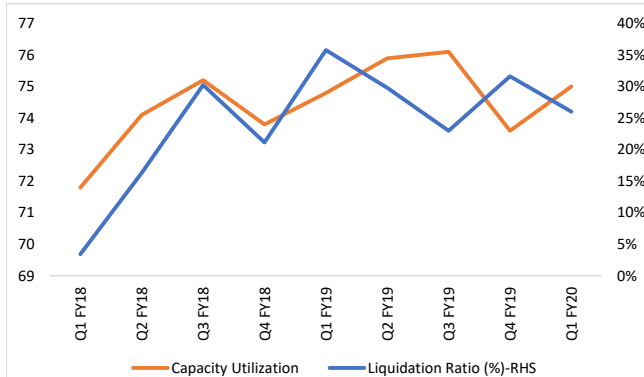
Source: RBI; IBBI; SBI Research

- As per the latest available number with IBBI, 2542 cases were admitted up to Sep'2019, wherein 1045 cases were closed either by way of appeal/review, Resolution plan, Liquidation etc. and 1497 cases are ongoing the process.
- The main feature of the IBC was that there would be a time-bound settlement of insolvency and faster turnaround of businesses. Further, the code was envisaged to make it easier for financial institutions and banks to deal with NPAs and have a faster and non-invasive resolution process. As of March 2019, the average resolution time for the resolved 94 cases was 324 days vis-à-vis the stipulated insolvency resolution timeline of 270 days.
- It is also observed that out of 2542 cases admitted, around 1232 cases i.e. 48% are initiated by operational creditors, while financial creditors initiated around 43% i.e. 1086 cases and remaining 9% by corporate debtors.**
- Given very small threshold limit of Rs 1 lakh, Operational creditors seem to be more aggressive in dragging the Corporate Debtor into NCLT eating the bandwidth of the courts and thereby delaying resolution of the bigger cases and defying the main objective of the IBC which is faster resolution and preserving economic value of the assets. Further, out of 1497 ongoing process, 36% of the cases are pending for more than 270 days from the date of admission.
- Recovery through Lok Adalats and DRTs has declined significantly alongside the number of cases referred partly indicative of growing clout of the IBC mechanism for resolution of stressed assets. **It seems even small creditors are preferring IBC rather than SARFAESI, DRT etc. and using the platform more as a recovery tool. This must be avoided.**
- Keeping in view of the increasing case load at IBC, Government should first significantly increase the minimum threshold limit of Rs 1 lakh and second, increase the number of NCLT benches in the country.** This will declutter the system and release bandwidth to the NCLTs/NCLATs to achieve the desired objective that is faster resolution and preservation of economic value of the assets.

#### IN 84% OF THE LIQUIDATION CASES THE REALIZATION VALUE IS LESS THAN THE LIQUIDATION VALUE

- It is also observed that more than 23% of the admitted companies ended with liquidation.** One way of looking into it is, at the time of lower demand and economic downturn there are not many takers of the stressed assets and hence entities ended with liquidation. For example, liquidation of companies and capacity utilization are positively correlated. Our data from Q1 FY18 to Q2 FY20, indicate that the correlation ratio between the above two is 0.67.
- However, it is important to note that 72.86% of the CIRPs ending in liquidation (427 out of 587) were earlier with BIFR and or defunct.** The economic value in most of these CDs had already eroded before they were admitted into CIRP. Further in 84% cases (i.e. 494 cases) the resolution value is less than liquidation value.
- Up to Sept'2019, 156 cases were resolved under IBC with a recovery Rs.1.38 lakh crore from the total admitted of Rs.3.32 lakh crore by Financial creditors i.e. 41.5%.** It is pertinent to mention that liquidation value of all these 156 companies is Rs.74997 crore only and the realization by financial creditors is 184% of the liquidation value.
- At the end of 30 September 2019, 498 corporate persons initiated voluntary liquidation. Most of these corporate persons are small entities. 289 of them have paid up equity capital of less than Rs.1 crore. Only 45 of them have paid -up capital exceeding Rs. 5 crore.

#### Capacity Utilization & Liquidation Ratio

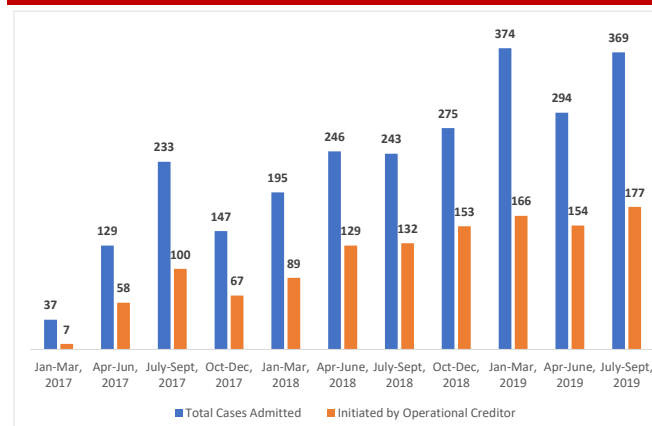


Source: SBI Research

Initiation of Corporate Insolvency Resolution Process				
Quarter	No. of Resolutions Processes Initiated By			
	Financial Creditor	Operational Creditor	Corporate Debtor	Total
Q4 FY17	8	7	22	37
Q1 FY18	37	58	34	129
Q2 FY18	94	100	39	233
Q3 FY18	66	67	14	147
Q4 FY18	84	89	22	195
Q1 FY19	99	129	18	246
Q2 FY19	95	132	16	243
Q3 FY19	106	153	16	275
Q4 FY19	187	166	21	374
Q1 FY20	127	154	13	294
Q2 FY20	183	177	9	369
<b>Total</b>	<b>1086</b>	<b>1232</b>	<b>224</b>	<b>2542</b>
<b>Share</b>	<b>43%</b>	<b>48%</b>	<b>9%</b>	<b>100%</b>

Source: IBBI; SBI Research

#### Number of Cases Admitted in NCLT



Source: SBI Research

Status of CIRPs - Sept'2019		
Status of CIRPs	Number of Cases	
<b>Admitted</b>	<b>2542</b>	
Closed on Appeal/ Review /Settled	186	
Closed on Withdrawal	116	
Closed by Resolution	156	
Closed by Liquidation	587	
Ongoing CIRP	<b>1497</b>	
> 270 days	535	36%
> 180 days ? 270 days	324	22%
> 90 days ? 180 days	276	18%
? 90 days	362	24%

Source: IBBI; SBI Research

**SECTOR-WISE BREAK-UP OF CASES ADMITTED TO CIRP**

- ◆ Out of total 2542 admitted cases, 1043 cases are from manufacturing sector which includes basic metal, chemicals, textiles etc. followed by Real estate, Construction etc.
- ◆ It is also observed that sector such as Construction, EPC, Electricity etc. where there are no hard assets have also been dragged to NCLT, where the asset realization value is very less and hence the liquidation value.
- ◆ **Efforts should be made to find a resolution of such companies outside the NCLT if possible as these could save resources and time for the already hard pressed NCLT benches!**

**RECENT SUPREME COURT JUDGMENT ON ESSAR STEEL IS CREDIT POSITIVE**

- ◆ Recent Supreme Court Judgement on Essar Steel has not only settled the issue regarding standing of Financial creditors over the operational creditors but also settled various other conceptual issues. The judgment will go a long way in promoting private investment and restore confidence of financial institutions.
- ◆ This will boost the earnings in the coming quarters as most of the banks had made substantially provisions in the account. Even assuming a provision of 80%, there could be a recovery/write back of more than Rs 30,000 crore.

**WILL IBC FACILITATE THE DEVELOPMENT OF CORPORATE BOND MARKETS?**

- ◆ After the IBC came into force, SEBI Chairman in a Summit organized by CII in August 2017 said that: *"From an investors' standpoint, an effective and robust bankruptcy regime is important for developing the corporate bonds market. Investors have been shying away from low-rated corporate bonds and even if the rating is of investment grade, given the high rate of defaults."*
- ◆ The recent empirical work on links between corporate bond markets and bankruptcy system predict that safe firms will issue bonds but higher risk firms for which insolvency is more likely, issue bonds as long as bankruptcy is efficient! Clearly, this might require more analysis in Indian context.
- ◆ The study goes on to conclude that by bringing all countries up to U.S. bankruptcy recovery (82%), it is estimated to increase the size of the global corporate bond market by almost \$1 trillion, or around a quarter of the current size. Much of this increase would happen in high-yield bonds.

**Sector-wise distribution of CIRPs as on Sept'19**

Sector	CIRP		
	Closed	Ongoing	Total
Manufacturing	450	593	1043
Food, Beverages & Tobacco Products	41	87	128
Chemicals & Chemical Products	48	50	98
Electrical Machinery & Apparatus	41	46	87
Fabricated Metal Products	31	33	64
Machinery & Equipment	48	70	118
Textiles, Leather & Apparel Products	79	92	171
Wood, Rubber, Plastic & Paper Products	48	71	119
Basic Metals	82	101	183
Others	32	43	75
Real Estate, Renting & Business Activities	201	299	500
Construction	88	186	274
Wholesale & Retail Trade	117	133	250
Hotels & Restaurants	27	39	66
Electricity & Others	22	47	69
Transport, Storage & Communications	30	42	72
Others	110	158	268
<b>Total</b>	<b>1045</b>	<b>1497</b>	<b>2542</b>

Source: IBBI; SBI Research

**ROLE OF CULTURE**

- ◆ **For IBC to be successful in India, culture must play a role.**  
As an *example*, there is distinct difference in the attitude towards debt in Asian societies. For example, Japan makes bankruptcy a personal failure, not a business failure. This characterization of bankruptcy in Japan often leads to tragedy for the individual, be it isolation from family or otherwise. Culture plays a substantial role in Chinese laws, especially its bankruptcy laws. If a father owes a debt, his sons or grandsons would be responsible for it; bankruptcy implies a life of burden for generations to come.
- ◆ Is Indian culture any different? Interestingly, in India the ordinary household even like the poor farmers take it personally upon themselves to repay their debt. Alternatively, making IBC successful in India could be just not a financial policy issue but should also be a cultural issue in the context of larger institutions.

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