

IBC reform needs to strike fine balance



BROADER FOCUS. Creditor-in-control model may need to be fine-tuned to make it a bit more debtor-friendly

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Since the introduction of the Insolvency and Bankruptcy Code (IBC) in 2016, there has been much debate on improving its effectiveness and efficiency. The code has been amended several times. As per reports, major amendments to the IBC are on the anvil, including introducing out-of-court resolutions or extending the pre-packaged scheme (a blend of debtor-in-possession/creditor-in-control model, so far, restricted to MSMEs) to large borrowers. It is expected that such measures can improve the overall efficiency of the code (by reducing the case burden on already stretched courts).

Any fundamental reforms (including those altering the balance between debtors and creditors) must, however, be viewed in the context of IBC's objectives and their potential impact. Much research has sought to establish that creditor orientation is vital and can boost lending and credit growth.

There has been much discussion around the creditor orientation (creditor in control model) of IBC. However, perspectives have been built around various ex-ante (prior to bankruptcy) and ex-post (post-bankruptcy) outcomes, leading to

different conclusions. For instance, from an ex-ante creditor-in-control and borrower behavioural/deterrence perspective, IBC has been hailed as creditor-friendly (disciplining effect/reduction of defaults). However, from an ex-post viewpoint, in terms of creditor recoveries (which, as per IBBI data, is around 32 per cent of admitted claims), IBC is often perceived as less than optimal.

There is a need to move away from the traditional perspective of creditor in-control towards a more holistic assessment. Considering the multiple assessment standpoints, mere control rights within IBC (upon replacement of existing management of the corporate debtor on admission) may not be sufficient, and there is a need for a broader focus around expected objectives/outcomes within the overall objectives of bankruptcy law. Ultimately, laws that meet the objectives of creditors, such as reducing corporate default risk ex-ante and improving overall recoveries (within the primary resolution objectives of IBC), may be considered creditor-oriented.

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mindful that policy levers (inputs) can have differential ex-ante/ex-post effects. To illustrate, IBC has achieved a certain level of ex-ante deterrence (considering IBBI data on withdrawals/settlements even before admission under IBC). Hence, the punishing effects of IBC (fear of consequences due to creditor-in-possession) seem to have had some positive effect when viewed from this lens. However, the same may not be the only optimal solution for maximising recoveries. Research has highlighted that the debtor-in-possession model where the existing management continues to manage the firm (as present in the US Bankruptcy) is also effective in this context. However, creditor-in-control can have a relatively more profound ex-ante effect due to the severity of its consequences.

IMPROVE CODE'S EFFICIENCY

IBC has already completed almost eight years in existence. Its introduction was when India, as recognised by the Bankruptcy Law Reform Committee, faced a twin balance sheet problem (NPAs/credit constraints). Hence, there may have been a need for a more disciplining law by giving creditors control rights. However, considering the reduction in NPAs in the economy, policymakers may now consider reforms aimed at improving the code's efficiency and maximising creditor recoveries (while at the same time taking care not to depress corporate sentiment).

This may even involve tweaking/partially relaxing the

creditor-in-possession model (by extending pre-packs/introducing out-of-court resolutions as contemplated). However, policymakers must be mindful of the potential trade-offs between ex-ante (deterrence) and ex-post (efficiencies/recoveries) effects while selecting such policy levers.

Thus, there is need for a more holistic assessment and targeted reforms. Further, creditor orientation must not be construed as a sole determinant of credit markets and at the cost of borrowers. Research has shown it is important to identify balanced levers (for instance, an overly harsh law with punitive sanctions while appearing creditor-friendly can impact firms' credit offtake, ultimately detrimental to credit markets).

Hence, in the next phase of reforms, policymakers may focus on more granular objectives and select policy levers accordingly towards a more targeted approach (while being mindful of their differential effects). While IBC has achieved some success in getting legacy issues off banks' books, the real benefits to credit markets will accrue only when the law induces lenders to lend more and firms not to borrow less. This can only happen when the code efficiently manages stakeholders' expected outcomes (ex-ante/ex-post). The regulator (IBBI) needs to do a fine balancing act.

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