

Unbalanced sheets



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We need a holistic bankruptcy code. RBI's Strategic Debt Restructuring Scheme is not the answer

THE RBI HAS released a "Strategic Debt Restructuring Scheme", which is aimed at improving the working of banks grappling with defaulters. The legal foundations and economic thinking of this scheme are questionable. India has a serious problem with how we handle defaulters. But strengthening the bankruptcy process is the remit of parliamentary law on companies, not the subject of banking regulation.

A large number of borrowers in India are in a state of default. At present, the machinery that kicks in upon default is quite messy. It destroys value on a large scale. The fear of messy defaults has restricted lending to only low-risk companies and, thus, harmed access to credit.

A third of the corporate sector is facing significant balance sheet distress. This is feeding back into the system as difficulties for lenders. Some banks may be spending good money after bad, giving more loans to distressed companies to make it look like things are fine. This reduces credit availability for healthy companies. Many banks are also lending less due to concerns about their solvency. This, too, reduces the credit that is available to healthy companies.

A vicious cycle may have set in. When banks pull back from lending, it hurts the macroeconomic situation; and when the macroeconomic situation deteriorates, it hurts the asset quality of banks. In the overall context of economic reforms, solving this problem is critical. While the bankruptcy process is a part of company law, the Companies Act, 2013, did not solve the problem. More work is required to establish a sound bankruptcy process.

The RBI's Strategic Debt Restructuring Scheme is about the terms that banks can (must?) write into loan agreements that would kick in at the time of default. There is a lack of clarity on its legal foundations. Unelected officials cannot make law. They can only write subordinate legislation (termed "regulation") when empowered to do so by an act of Parliament. The text released by the RBI does not show how it has

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come to have such powers. It is not clear that the RBI needs to instruct banks on how to write contracts. The RBI has not followed due process in the drafting or the release of this purported "regulation".

When a firm defaults, money is generally owed to many entities: other firms, banks, other financial institutions, bond holders, etc. The bankruptcy process has to take a holistic view of the creditors and establish protocols for negotiation. Anything done by a sectoral regulator (such as the RBI) will be an incomplete and faulty solution to the problem, even if it were grounded in sound legal homework.

The RBI's scheme writes down, in considerable detail, what must happen. For instance, it says that the Joint Lenders' Forum must take 51 per cent equity shares, it details the procedure to be adopted for the valuation of the shares, it mandates that the conversion from debt to equity must be approved within 90 days, etc. This is a bureaucrat's view of bankruptcy.

If only bankruptcy were so simple. When a firm defaults, there is no fixed recipe for what must come next. Perhaps the lenders should take shares and run the firm. Perhaps existing shareholders should pay off the lenders and extinguish the debt. Perhaps a third party might come along and take control of the company. The exact percentages and prices cannot be predetermined. The most important element of the bankruptcy process is the negotiation that takes place between the creditors on determining the next steps to be taken. This negotiation is about business judgement. There should be no role for the legislature, the executive or the judiciary in determining the right answer. The RBI's scheme micromanages the process. It attempts to replace subtle business judgement with a fixed bureaucratic scheme. This is bad economics.

The RBI's mandate is to ensure that banks are safe and sound. Their past forays into the bankruptcy process have resulted in poor outcomes. For example, the RBI wrote regulations for asset restructuring companies,

through which banks have offloaded bad assets in exchange for paper, which is overvalued because of the central bank's regulations. Also, the RBI established the Corporate Debt Restructuring Mechanism, which turned into an instrument for banks to postpone bad news. The new scheme could perhaps give rise to a new class of opportunities, thanks to which banks will be left holding 51 per cent of the shares of unlisted companies in exchange for loans that are not repaid.

The scheme is thus a disappointing combination of poor legal spawework and bad economics. While India desperately needs reforms in the bankruptcy process, this is not a problem that is the RBI's mandate to solve. Nor does the RBI have the expertise to solve it. Only parliamentary legislation can cut through the problems of the bankruptcy process in India and create a sound framework for all creditors — not just banks — to negotiate after a default. The government has already tasked the Bankruptcy Law Reforms Committee under T.K. Vishwanathan to draft a bankruptcy code. This is one of the most important initiatives of the government.

A key problem of the present environment is the multiplicity of frameworks — Debt Recovery Tribunal, Corporate Debt Restructuring Mechanism, Joint Lenders' Forum, etc. This results in forum-shopping and increases delays. The bankruptcy process has become drawn out and involves battling it out through many steps. The RBI's scheme adds another layer of complexity to an already complex system. The bankruptcy code needs to be a clean and modern replacement for these multiple procedures.

The RBI's job is to ensure that banks are safe and sound. How come they gave out so many loans that went bad? How are banks hiding bad news by holding assets on their books at a value that is far higher than the market value of the assets? The RBI should be asking questions about failures of regulation and supervision because of which India is once again staring at a banking crisis.

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