ILLUSTRATION BY BINAY SINHA

How IBC changes the game

The Insolvency and Bankruptcy Code is beneficial to the extent it generates modified behaviour on the part of managers and lenders

The implementation of the Insolvency and Bankruptcy Code (IBC) is facing difficulties. For the largest firms, there is a whiff of SICA (Sick Industrial Companies Act) in the air, with endemic delays. However, the incentive effects of the IBC run deeper. Chief executive officers (CEOs) of the largest firms will be relatively arrogant. Other CEOs face substantial inconvenience owing to the threat of the IBC. Looking forward, this is likely to yield behavioural changes including: Less leverage, and early responses to financial distress ranging from bringing in new equity capital to selling off the firm. Lenders will be more wary about firms where the IBC is not a threat.

The empirical analysis (*http://bit.ly/2EUD1m7*) has revealed two important facts about the IBC. Of the cases admitted at the NCLT, about a year later, half have not completed. For the biggest cases, 90 per cent are not completed in a year. There are numerous large delays, way beyond the 180- or 270-day deadline in the Code.

In the field of public policy, we have a "Law of unintended consequences", where policymakers who think one move ahead get surprised at the outcomes. We got a teachable moment of this Law, with Section 29A of the IBC, which debars participation in the insolvency resolution process by promoters and their family members. This has ended up entrenching promoters through enhanced delays.

In the policy discourse, we have retreated from the clear economic thinking of the BLRC (Bankruptcy Law Reforms Committee) to a yearning for nurturing. Many people in the state apparatus associated with the IBC are using words like "stakeholders" and "revival". For those of us old enough to remember the 1980s, there is a whiff of SICA in the air.

SNAKES & LADDERS

AJAY SHAH

These are serious problems and need to be addressed. The full impact of the bankruptcy reform, however, is more positive than meets the eye. To see this, we should focus not on the outputs of the IBC (e.g. the number of firms resolved, delays) but on how the IBC changes the incentives of the CEO.

In the extreme, for the largest firms, the IBC is merely a cost of business. Investments of ₹100 million to ₹500 million in payments to lawyers are likely to induce delays of many years. These payments to lawyers are not large enough to matter to the largest firms. Hence, the IBC has the least impact upon the behaviour of the biggest firms. For them, the IBC does not generate significant pain. As a thumb rule, I think that by the time we have a balance sheet of ₹500 billion, payments to lawyers are too small to matter to the CEO. Here, the IBC is not a threat.

By the time we get to smaller firms, however, paying hundreds of million rupees to lawyers starts to hurt. This is the zone where the IBC is a threat, and therefore impacts upon behaviour. Consider the thought process of the CEO of a ₹50-billion company. Here, default followed by the IBC process can generate substantial pain. CEOs are changing their behaviour in response to this threat. In what ways will behaviour change?

There would be less leverage. CEOs would be inclined to obtain more equity capital to have a greater buffer against adverse events. For a contrast, infrastructure development in India is a risky business, where, in the past, we have had too much debt financing. Looking forward, this would change. Reduced leverage would make projects safer.

When adverse events do come about, the CEO sees difficulties well before anyone outside the firm. In the past, we have had a relaxed attitude, where the CEO believed they would ride through a coming storm with a little bit of default here and there. The IBC changes this calculation. Adverse events would force the CEO to choose between "fight" and "flee".

To "fight" is to bring in additional equity capital, and to wage war inside the firm so as to improve the working of the firm, so as to overcome the incipient stress. This would yield more productive firms. These battles, fought all around the Indian economy, would foster GDP growth. Improved productivity by these firms would increase competition in the economy.

To "flee" is to sell the firm while the going is still good. For many firms, the looming difficulties that they see in their next few years will encourage selling off the company. This decision is also shaped by the extent to which a competent next generation is available to take over a family business. These decisions to flee will generate an increased flow of control transactions. Firms which have not yet defaulted — and have no visible connection to the IBC — will be sold off to listed companies or to control-oriented private equity funds. To the extent that many smaller firms are sold off to existing large listed companies, this would decrease competition in the economy.

Traditionally, the family business was a family jewel, intended to be handed down the generations. These attitudes have been changing over the last decade. The IBC increases the extent to which promoters will sell off the business. Over the coming decade, we are going to see a new wave of dispersed shareholding firms in India, and these will commensurately require a fresh focus upon our building the institutional mechanisms to bind the interests of the managers to the interests of the shareholders.

These factors will influence the behaviour of lenders also. It is relatively unsafe lending to the biggest companies, where the management is not afraid of the IBC. On the other hand, by the time we get to smaller firms, where the IBC is a significant threat, the behaviour of the firm vis-a-vis lenders is likely to be much better. Access to debt capital for these firms will thus be enhanced.

The IBC reform is not working well for the biggest companies. But once we get to the zone of firms where the IBC is a credible threat, there are important gains. These gains are not just in the transactions that flow through the IBC. The biggest gains for the economy come from the extent to which the threat of the IBC generates modified behaviour on the part of managers and lenders.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi