ILLUSTRATION: BINAY SINHA

Stabilising stressed firms

A formal bankruptcy process stabilises the stressed firm, and directs the energy of lenders into the right channel

SNAKES & LADDERS

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Once a firm has substantial debt, borrowing is an everyday activity; new debt is taken to repay old debt on a regular basis. When lenders become suspicious, this flow of borrowing gets restricted and this creates stress. Stressed firms are then under pressure to obtain cash to pay down debt. All or most lenders tend to step forward and ask for their money back. In the absence of a formal resolution process, the management has the ability to choose who gets repaid. The great advantage of a formal resolution process is that an order of priority is written into law. This calms all lenders and creates stability.

Some firms borrow occasionally. They need to worry about how lenders think about them only at the time when fresh borrowing is desired. Other firms build up substantial borrowing. Once there is a lot of borrowing, the normal way to repay old debt is to take on new debt. Borrowing now becomes a critical raw material to keep the company going. Every month or two, the company has to go to lenders and ask for new debt.

A company that regularly borrows is on a tight leash. At any point in time, if the credit risk perception of lenders changes, it can interrupt the flow of lending. This is a problem particularly in India, where the bond market works poorly. We do not have a graceful escalation of the interest rates charged as credit quality degrades. Instead, when the credit quality worsens a bit, credit access chokes.

As a consequence, we get a few leveraged firms in an uncomfortable place, where there are repayments coming up, and fresh credit market access is not forthcoming. Let us first consider the ideal situation: The firm is solvent and has liquid assets. In this case, it is possible to get a graceful deleveraging. One by one, the firm sells off its assets, obtains cash and meets all the repayments.

India is a much more capable financial ecosystem today, as compared with the conditions of 10 or 20 years ago, in the extent to which markets exist for assets such as a loan book, a division, or a subsidiary. It is now much more possible to hawk such assets and get a reasonable transaction within a reasonable time. This takes care of some situations, where lenders have turned their back on a healthy company. The assets are liquidated at decent prices, and repayment obligations are met in time. The firm deleverages in a graceful fashion, suffers from a bruised ego, licks its wounds, and lives on to fight another day.

Things need not work so nicely. Suppose the firm has illiquid assets. In the hunt for cash, it may be forced to sell good assets at a steep discount. This induces a loss which is paid for by equity capital. Alternatively, suppose the firm is actually insolvent, where the value of its assets is not large enough to pay off all its lenders.

Under these conditions, sale of assets keeps the firm in a downward spiral. Each sale of asset leaves the remainder of the firm looking worse. As an example, suppose there is a balance sheet of ₹100 with ₹20 of equity and ₹80 of debt. Under a fire sale, ₹50 of assets are sold for ₹30. While this produces ₹30, which is used to meet debt obligations, the loss of ₹20 wipes out the equity capital, which makes the firm look worse.

Alternatively, suppose there is a balance sheet of ₹100, where ₹50 are good assets and ₹50 are bad assets. Suppose the ₹50 of good assets are sold off for the full value of ₹50, and debt is paid off. But after this, the firm has ₹50 of bad assets against liabilities of ₹20 of equity and ₹30 of debt. This firm does not look so good.

In either of these two cases, the early moves of deleveraging to meet debt repayments do not stabilise the firm. Access to fresh debt remains blocked. The phone lines are ablaze as all existing lenders clamour for prepayment.

This is where the formal institutional apparatus of a bankruptcy process helps. Under the Insolvency and Bankruptcy Code (IBC), there comes a date where the corporate insolvency resolution process (CIRP) commences, and a "calm period" starts, where all claims against the firm are suspended. This is the opportunity for the committee of creditors to stabilise the firm. And if the firm cannot be protected as a going concern, then there is a clear waterfall that governs the order in which various creditors are paid off.

Such a rule set stabilises the lenders. They channel their energy into the constructive process of being on the committee of creditors, trying to restructure the firm in a way that maximises their own value. There is no possibility open, for any one lender, to pressure the management trying to get his/her own money out. This is the key difference in India today, between stress in a non-financial firm versus stress in financial firm. For the former, there is an orderly institutional mechanism, the IBC, and for the latter this is lacking.

The correct design, which was done by the Financial Sector Legislative Reforms Commission (FSLRC), involves two elements. For financial firms that make intense promises to unsophisticated households (e.g. banks) and for systemically important financial firms (e.g. HDFC), the bankruptcy process would work through a resolution corporation (RC). This is encoded into the Financial Resolution and Deposit Insurance (FRDI) Bill. For all other firms, we should have the IBC in its full glory, as envisioned by the Bankruptcy Law Reforms Committee (BLRC). We may emphasise that this split is not a simple financial vs non-financial firm's separation. This two-part machinery needs to be put into place.

The other key weakness of our environment is the lack of a sensible bond market. When credit risk goes up, it should be associated with costlier borrowing, and not a collapse in credit market access. This collapse in bond market access is the key culprit of the present environment, which is destabilising firms. Addressing this requires bond market reforms.

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