

How IBC can improve the lending ecosystem





The Insolvency and Bankruptcy code, 2016 (IBC) was a reform to India's insolvency resolution procedures and its five-year journey has brought important lessons for the credit industry. IBC was introduced to strengthen the banking system, do away with multiple time-consuming processes and enforce a smooth insolvency resolution. To achieve this objective, it repealed erstwhile insolvency laws of Presidency Towns Insolvency Act 1909 and Provincial Insolvency Act 1920 which regulated insolvency resolution for individuals and the Sick Industrial Companies Act 1985 which regulated insolvency resolution for corporates. It further amended multiple other laws including Recovery of Debts and Bankruptcy Act, 1993, Securitization and Reconstruction of the Financial Assets and Enforcement of the Securitization Act, 2002, and the Companies Act, 2013 to channelize the proceedings through a single window clearance for hassle free resolution.

So far, recoveries in IBC have been better than in the erstwhile regime. As per RBI's report on Trend and Progress of Banking in India 2019-2020, scheduled commercial banks observed 45%¹ recovery in IBC. The 2020 edition of World Bank ranking depicts the improvement in India's rank in "Ease of Resolving Insolvency" from 136² in 2016 to 52³ in 2020. Although substituting multiple laws has proven to be impressive, delays in resolving cases have been unsatisfactory. The Parliamentary Committee⁴ too has raised its concerns regarding the delay in resolution process and low recovery rates.

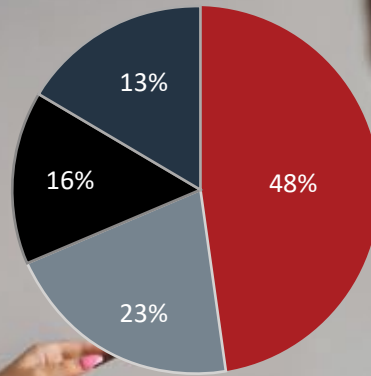
¹Reserve Bank of India. 2020. Report On Trend And Progress Of Banking In India 2019 – 2020

²World Bank. 2016. Doing Business 2016: Measuring Regulatory Quality and Efficiency. Washington, DC: World Bank

³World Bank. 2020. Doing Business 2020. Economy Profile of India. <https://www.doingbusiness.org/content/dam/doingBusiness/country/i/india/IND.pdf>

⁴Economic Times. 20 August 2021. Parliamentary committee calls for overhaul of bankruptcy code <https://bit.ly/3DEbnEJ> (Last accessed 31 August 2021)

Fate of Debtors going under IBC



■ Commencement of Liquidation

■ Appeal/review/settled

■ Withdrawal u/s 12A

■ Approval of resolution plan

⁵Source: Quarterly newsletter for January – Jan- March 2021, IBBI

Approximately 48% of the cases admitted up till March 31, 2021, under IBC were ordered to be liquidated. Companies ordered for liquidation had an aggregate claim of INR 6.47 lakh crores⁵ whereas their assets were valued at INR 0.46 lakh crore. These numbers signify the deterioration of asset value of defaulting company once it is ordered for liquidation. Although 13% of Corporate Debtors referred under IBC were revived with a resolution plan, only 37% of the total obligation was recovered in these cases. While the IBC aims to conserve value, it might be helpful to look at the lending process stymie the deterioration at a step earlier using the learnings from IBC proceedings. Even though IBC aims to not deprive the lenders of their rights, with the benefit of hindsight, it is important to note the need for taking preventive measures to avoid the consequential loss of asset value.

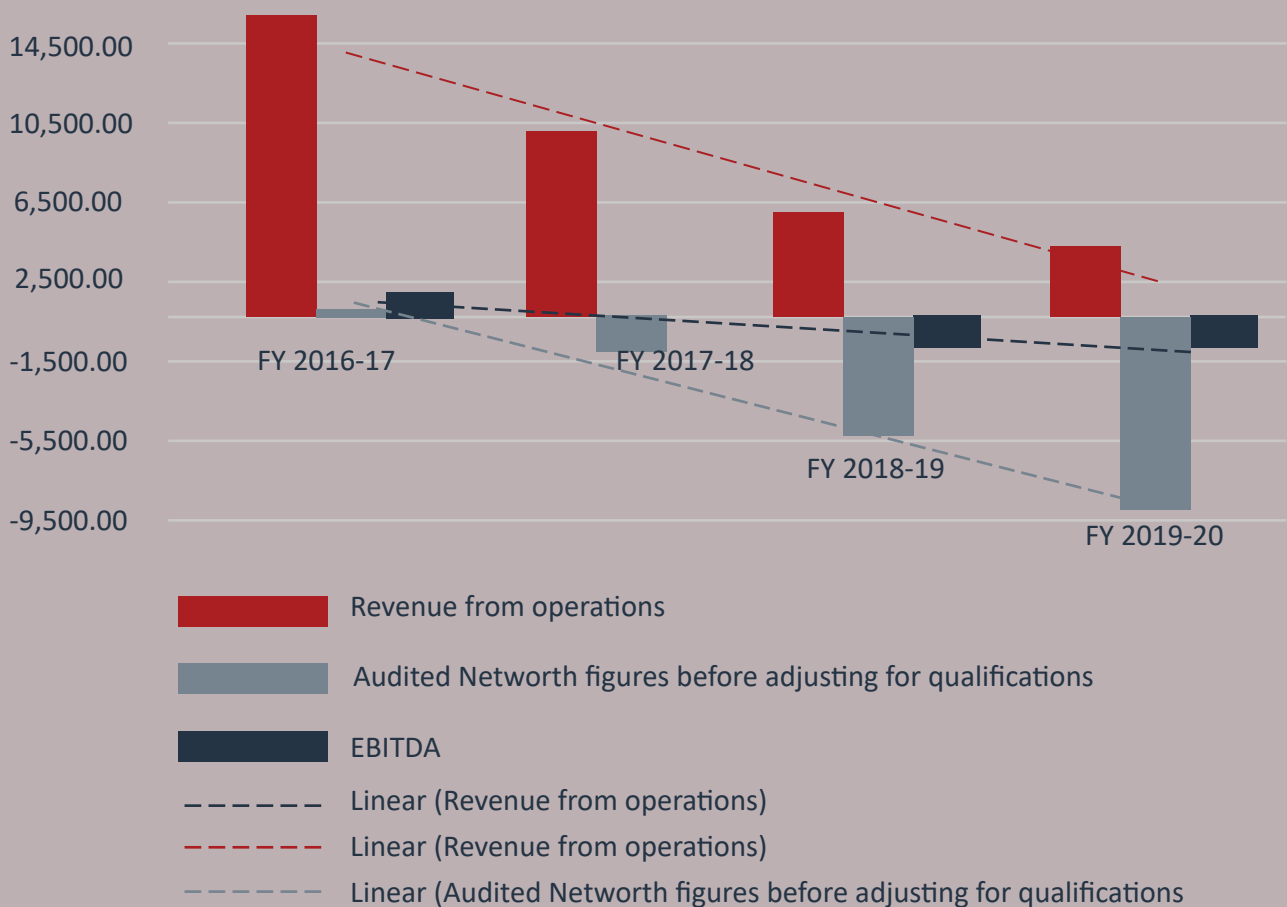
Majority of the companies that land under IBC show typical trends like adverse debt service ratios, declining revenues, eroding net worth indicating their weak operational viability. In the case of a rather prominent yarn company admitted into IBC in April 2021, the financials had shown signs of deterioration at least 4 years prior.

⁵Insolvency and Bankruptcy Board of India. Quarterly Newsletter. Jan-Mar2021 | Vol.18



Following trend is observed in financials of a typical company referred in IBC. Some of the indicators were as follows:

Financial Condition in a nutshell

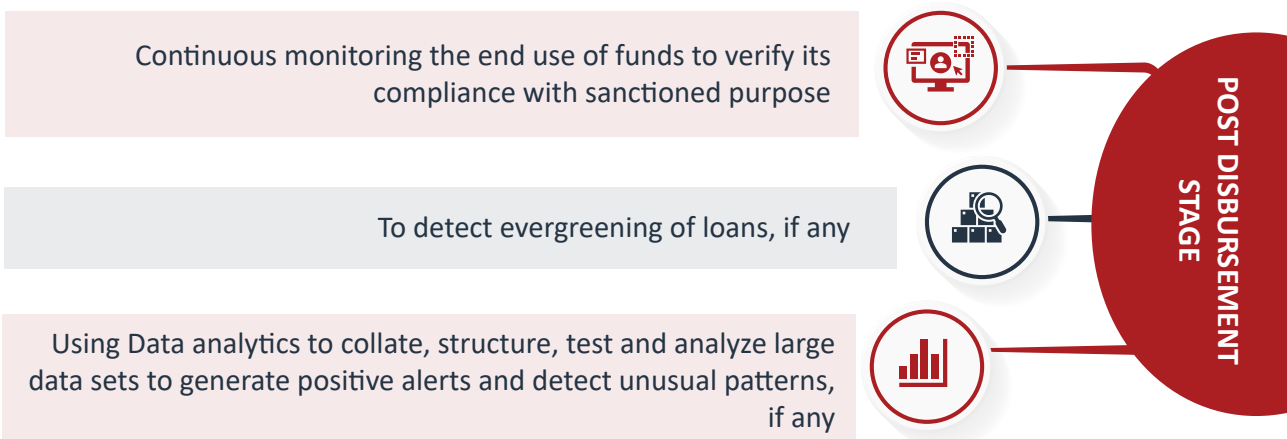
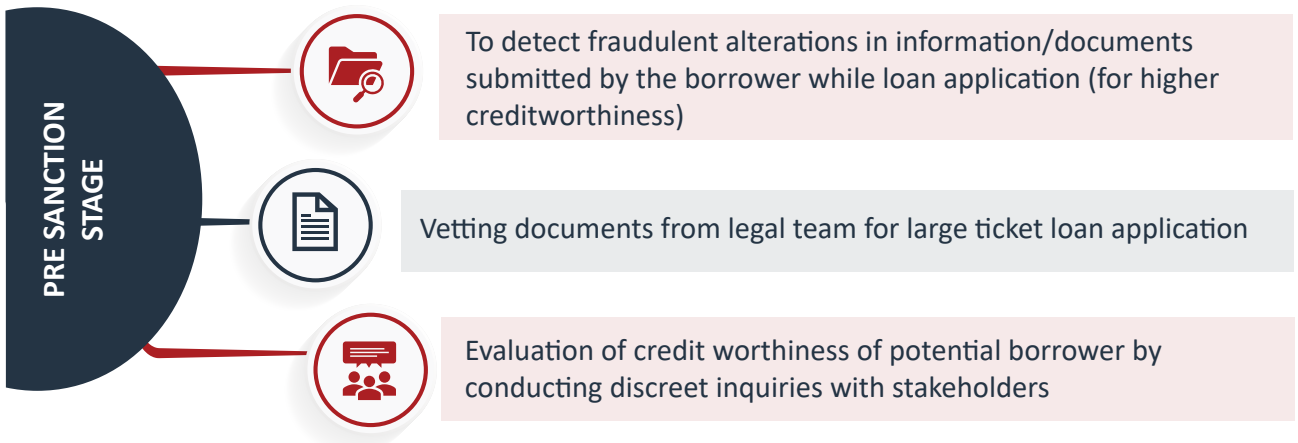



This is not to say that credit flow should not be allowed to deteriorating companies. But learnings from audits conducted by banks (under RBI’s circular of 2016 which allows banks to conduct forensic audit of “red flag accounts” to determine the account as fraud) and under the IBC would have us take a more stringent view of not just the financials - but of their veracity. Financial statement frauds, heavy reliance on related parties, inflated transactions, complicated organization structures, offshore entities in tax havens are common features of companies showing signs of fraud under IBC. Seldom a case comes by, which does not have one or more of these. Proactive measures need to be taken to prevent accounts from going bad on account of fraud. Investigative due-diligence, forensic audits, continuous monitoring of borrower’s account, monitoring existence of any early warning signals, end-use monitoring of loans can act as a deterrent against repayment defaults.



Already a procedure exists with lenders to remedy some of the early warning signs. RBI has devised Early Warning Signal (EWS) mechanism which mandates all the financial institution to report the red flagged accounts identified based on presence of signals (EWS). These signals put the banks on alert for identifying fraudulent activities. Moreover, additional checks at different stages of loan life cycle are recommended by RBI at pre-sanction, disbursement, and annual review stage.

In addition to the checks recommended by RBI, enhanced investigative due diligence and end-use monitoring services by forensic experts can help financial institution at pre-sanction as well as post disbursement stage of the loan life cycle.





Continuous monitoring and in-depth periodic reviews of such accounts bring into the lender's notice these red flags and the potential inability of the company to repay the existing loans. Investigative procedures undertaken at an early stage would suggest a suitable internal or external restructuring plan for company's revival. Developing a restructuring plan would succor in reviving the company at an early stage instead of waiting for a resolution plan under the IBC. Moreover, it would prevent the financial institution from lending further credit to a company that perhaps needed a revival strategy.

With the financial strain on the economy due to COVID-19, the NPAs are expected to see a surge which further underlines the need for building stronger lending models by creditors. A key step in this will be investigative due diligence on promoters, and asset-tracing and not just relying on financial review as traditionally happens. In the case of one of the leading steel manufacturing companies⁶, Serious Fraud Investigation Office (SFIO) found 155 shell and bogus companies floated to divert the loan funds obtained from banks purportedly taken for capital expenditure and working capital requirements. Arguably an investigative due diligence in such cases can warn the lenders of the existing structure and deter others from creating one.

Although attachment of assets as a part of court proceedings aids in the recovery of funds, it is a cumbersome and time-consuming process to undertake, and the results may not be favorable to all the lenders. In a leading Infratech company⁷, the Supreme Court denied third party lenders to be considered as financial creditors. Even though the assets of the subsidiary were mortgaged for the loans of the holding company, the creditors of the holding company were not considered as creditors to the subsidiary. This landmark judgement underlines the need for creditors to exercise enhanced due diligence in cases of debt restructuring and financing proposals.

⁶BusinessToday.in. How a web of shell companies helped Bhushan Steel promoters siphon off funds. 16 September 2019. <https://bit.ly/3oEsMc2> (Last Accessed 31 August 2021)

⁷Business Standard. SC asks Jaiprakash Associates to return pledged land to group firm Jaypee. 26 February 2020. <https://bit.ly/3GMJ49d> (Last accessed 31 August 2021)

In case of any suspicion during periodic review undertaken by financial institutions, steps can be taken to initiate a forensic audit on the corporate borrower to verify whether loan funds granted were used for the sanctioned purpose. Forensic audit in the above case could have uncovered opaque structure formed by promoters.

Once the case is referred to IBC, the responsibility for handling operations is shifted from management to resolution professional. Generally, the revenue starts plunging during the moratorium period due to negative publicity and increased attrition of the workers and employees. The company continues to incur fixed costs such as fees of resolution professional, legal proceedings, rent, electricity and other such operational cost.

The time taken for the IBC procedures to conclude can vary from case to case. A lengthy IBC process blocks the credit flow to more profitable and productive ventures. Stringent checks and balances by proactive due diligence and investigative procedures can promote healthy credit practices in the industry.

The evolving legislative landscape around IBC has shown that there is potential for strengthening the '*upstream procedures*'. A stitch in time while increasing leverage can save nine during the recovery procedures. The benefits will be felt in cleaning the existing books and preventing further losses.

Credit is always in limited supply. It, therefore, bodes well for the lending economy to divert the funding towards projects which present fewer red flags. While IBC procedures might help in retaining some asset value, it does not hold the promise of, say, a restructuring deal. If extending credit can be more useful, it needs to be justified on an anti-fraud risk framework where an in-depth forensic exercise can rule out any fraudulent play. The lenders need to come up with a vigilance mechanism where fraud-fighting is not too cumbersome to delay lending, and not a *post-facto* exercise with limited impact. A more proactive and vigilant lending process can act as a filter between the lenders and regulator by separating fraudulent accounts from those fallen on hard times.