Insolvency and Bankruptcy Board of India

Subject: Development of Markets for facilitating Corporate Transactions.

Insolvency and Bankruptcy Code, 2016 (hereinafter Code) was enacted in May 2016, the corporate insolvency transactions and corporate liquidation transactions were enabled through the respective regulations by 15th December, 2016 and the first transaction had its beginnings on 17th January, 2017. More than 500 transactions in different stages of the corporate insolvency resolution process (hereinafter CIRP) resulted in 13 resolutions and 45 liquidations till date. The IBBI has been modifying regulations from time to time to meet the emerging needs; it has amended the CIRP regulations five time since its inception in response to market requirements, deliberations with other regulators, and policy framers. However, markets seem to require further institutional arrangements and policy prescriptions to ensure greater resolutions. While the freedom of exit is now well established in the ecosystem, it is also important to ensure that transactions find their way well into resolutions as the first alternative, unless liquidation is the most plausible solution. The CIRP functions in a very strict time schedule. The development of markets related to the process have a greater promise to make the process geared towards resolution. Development of markets for the various constituents of the insolvency ecosystem is therefore a critical issue.

A. Market for Resolution plans

1. An Economic Times (ET) editorial on 28thFebruary, 2018 (Annexure A), in connection with the CIRP resolution of Monnet Ispat, one among the 12 accounts referred by the RBI for corporate insolvencydiscusses, in particular, the level at which the asset is priced under CIRP, the replacement cost and the very low costs that the buyer will incur in the transaction. The editorial discusses the massive haircuts to the financial creditors, in particular, the banks, loss to the ecosystem, and ultimately the tax payers. The prices offered are beneficial to the buyer of the distressed asset in the absence of deep markets for such assets. With infrastructure assets being sold at a fraction of the cost of setting up new capacity, the acquirers would become windfall beneficiaries at the cost of the banks and thus be a burden on taxpayer, since banks would require recapitalisation. The Editorial further suggests bringing long term funds such as EPF and NPS as players in distressed assets market to increase competition, thus fetching better

price for the assets and lesser burden on the taxpayer, and the gains to acquirers of assets at deep discount be widely shared with the public.

2. In another editorial the ET on 6th March, 2018 (Annexure B), highlights that a corporate represents an amalgam of people, skills, capital, machinery, vision, ambition, brand, goodwill- each having a value by itself which multiplies when brought together in a company. A company's valuation represents the present value of future income streams. A higher value represents efficiencies and optimal productivity, if its performance is sub-optimal, someone else will find better value at a price superior to its present value, and run it better. A similar analogy is made to distressed assets. A person paying highest price will get the asset to generate maximum income, and thus the choice of highest bidder, as earlier guided by IBA and now Ministry of Finance, is appropriate. The editorial flags the issue of widening the market for distressed assets. A larger number of players would ensure that there is greater competition and thus, better price discovery of stressed assets, which have reasonable value and are currently being sold cheap, to the detriment of Public Sector Banks and the taxpayer.

3. The resolution of stressed assets cleanses the books of the banks enabling them to lend afresh, adding to the momentum of economic growth. With more than 15% of the PSBs gross advances being stressed and a significant majority of these being non-performing assets (NPAs), concentration of many of these NPAs in select sectors such as infrastructure, power, telecom, metals, textiles, etc may open up a market for resolution assets. Given the scale of assets that needs restructuring, potential investors may be interested in bidding for these assets. While the investors would look towards buying these at steep discounts, this would also imply significant haircuts for financial creditors, and largely PSBs debt, and thus tax payer's money.

4. The Code aims at maximisation of value through resolution if it is a viable business. It envisages resolution within the firm as a going concern, as closure of the firm destroys organisational capital and renders resources idle till reallocation to alternate uses.

5. Once a company is under CIRP, a resolution applicant that offers the best value to the creditors of a corporate debtor (hereinafter CD) steps in to acquires the business. The existing owners may be ineligible or not in a position to match the revised terms and conditions that creditors expect; the resolution process should facilitate for an outside investor to see value in the company and buy ownership under a new arrangement with the creditors and claimants.

This requires a transparent and equitable process that enables outside investors with risk capital to participate as resolution applicants during CIRP. Ensuring a broader set of resolution applicants ensures that better price discovery will emerge. Investors can participate in the resolution process as resolution applicants based on eligibilities introduced in the Code and the regulations framed thereunder.

6. In the recent past, IBBI has made numerous attempts to facilitate participation of a broader and larger set of potential resolution applicants in the CIRP. These include, amendment of IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (hereinafter CIRP Regulations) on 6th February, 2018 wherein the potential resolution applicants are mandated to receive at least a reasonable number of days for due-diligence and preparation of resolution plan after final request for proposal (hereinafter RFP) is issued; making it essential for the RFP document to provide for evaluation matrix finalized by the CoC, in an attempt to bring transparency to the criteria of evaluation of resolution plans received from resolution applicants; a public consultation document on contents of RFP hosted on the website of IBBI for comments, based on which, a guideline may be issued specifying the mandatory contents of RFP; the amendment also provides greater flexibility to a potential resolution applicant by allowing to propose change in portfolio of goods or services and/or change in technology of the corporate debtor as part of resolution plan. In order to ensure transparency and equal opportunity to larger number of potential resolution applicants/investors, the amendment provides for brief particulars of the invitation for resolution plan in Form G of the Schedule to be placed on the website of the corporate debtor; and the website designated by the Board for the purpose. IBBI has designated its website for the purpose.

7. A resolution plan, irrespective of its form and content, represents a value for all stakeholders of the corporate debtor.The issues for deliberations are:

(i) How to further deepen market for resolution applications to ensure a vibrant market exists and thus offer competitive process and better price discovery.

(ii) Should the Government allow large fund houses (NPS, EPF) to participate in the process.

(iii) Is there a case for small industries below a threshold where ineligibilities are further relaxed, to bid for these companies?

(iv) Is there a case for specialised M&A experts who can increase the reach to resolution applicants, get suitable bidders, and help in negotiations, on a success fee basis.

(v) Capability and motivation of CoC- should be groomed to be business savvy, should evaluate the proposals to their best interest.

8. Buying/ investing in distressed asset markets require specialized expertise and risk capital with higher expectations on return. Further, conducting business of CD during CIRP also requires capital to pay for resolution costs and ongoing business costs and expenses. The Governing Board may like to consider development of a market for such assets with a well-developed platform for facilitating transactions to ensure transparency and reach of the assets for suiters.

B. Market for interim finance

9. An interim resolution professional (hereinafter IRP)is mandated under section 20 of the Code to make every endeavour to protect and preserve the value of the property of the CD and manage the operations of the corporate debtor as a going concern. For these purposes, the IRP has the authority to raise interim finance (hereinafter IF) provided that no security interest is created over any encumbered property of the CD without the prior consent of the creditors whose debt is secured over such encumbered property. However, no prior consent of the creditor is required where the value of such property is not less than the amount equivalent to twice the amount of the debt. Section 25 of the Code mandates the resolution professional (hereinafter RP) to preserve and protect the assets of the CD, including the continued business operations of the CD. For these purposes, the RP has authority to raise IF subject to the approval of the committee of creditors (hereinafter CoC). Section 5(15) of the Codedefines 'Interim Finance'to mean'any financial debt raised by the RP (including the IRP) during the insolvency resolution process period'. Under section 5 (13) of the Code, "insolvency resolution process costs" include the amount of any IF and the costs incurred in raising such finance. Resolution plan identifies specific sources of funds that is used to pay the insolvency resolution process cost.

10. Duringthe CIRP, the IRP / RP needs to run the CD as a going concern and may need IF. However, if the CD is not in pink of its health or does not have adequate liquid assets to

continue its operation, at least at the same level of capacity and efficiency as in the pre-CIRP period, raising IF may be difficult. The failure to operate it as a going concern may reduce the enterprise value of the CD leading to failure in attracting good valuation or viable resolution plans. This may eventually push the CDs in some cases towards liquidation, which may not be consistent with the objective of the Code. Therefore, it may be useful to facilitate development of a market mechanism that makes available flow of IF to CDs under CIRP.

11. The IP faces myriads of challenges in obtaining IF for the CD despite the protection available under the Code.These include:
    (i) Banks may not be willing to provide IF as they may apprehend it may be used to pay dues of vendors who are typically related parties of promoters of the CD.
    (ii) The existing creditors may not have capacity to extend IF.
    (iii) The CD may not have unencumbered assets to be offered as security to cover IF.
    (iv) Banks may be reluctant to provide IF in the absence of clarity on norms for provisioning and asset classification in respect of new finance to an NPA account, particularly where insolvency proceedings have commenced. It prima facie appears that regulations governing banks, NBFCs and asset reconstruction companies require them to make 100% provisioning on such loans irrespective of the borrower.
    (v) Foreign funds may be willing to provide IF. The restriction on debt investment may come in their way. They may be reluctant to provide IF as the lock-in for foreign corporate debt is three years.

12. The US Bankruptcy Code offers legal protection to interim financiers in the form of an escalating series of inducements. These range from granting post-petition finance the status of unsecured first-priority administrative expense, all the way to a lien that is senior or equal in priority to pre-existing liens. The UK Insolvency law also allows new loans that have higher priority over existing charges.Globally, there is a well-developed market forspecial situation funding. There are lenders that specialise in and focus on investing in this area.

13. A lender may be willing to extend IF, which is a short term and risky finance, if it is offered above normal interest rates, as well as legal protections. In the event of approval of a resolution plan by the adjudicating authority, the IF is repaid in full along with interest and

other costs due on it till such day of repayment. However, regulation 27 of Liquidation Regulations provide: “In case of rent, interest and such other payments of a periodical nature, a person may claim only for any amounts due and unpaid up to the liquidation commencement date.” This implies that interest on IF availed for the benefit of a CD ceases to bear interest after the liquidation commencement date. Since liquidation is usually a long process, the lender would not receive repayment of IF for a long period and during this period IF may not earn any interest. Inability to earn interest until repaid in full discourages the financiers to extend IF. There was a view that since IF and the costs incurred in raising the same are considered as part of ‘insolvency resolution process costs’, interest payable on IF should also constitute costof raising IF and, therefore, not be subject to the restriction in regulation 27.

14. The Advisory Committee on Corporate Insolvency and liquidation that met on 10-11thFebruary, 2018 deliberated that while incentives should be considered, accrual of interest comes to an end after liquidation of a corporate debtor commences since the corporate debtor cannot enter into/ honour previous contracts after liquidation order. The Advisory did not favour amendment to regulation 27. Instead, it recommended that in order to incentivise the financer, tax incentives could be considered.

15.Banks may be reluctant to provide IF in the absence of clarity on norms for provisioning and asset classification in respect of new finance to an NPA account, particularly where insolvency proceedings have commenced. It appears that regulations governing banks, NBFCs and asset reconstruction companies require them to make 100% provisioning on such loans irrespective of the borrower. Issues relating to provisioning has been taken up with the RBI.

16. Further, foreign funds may be willing to provide IF. It appears that there is restriction on debt investment. There may be hesitation to provide IF as the lock in for foreign corporate debt is three years. Lack of supply in the market may lead to skewed development of interest rates on IF.RBI has also been requested to consider waiver of the lock in period for foreign corporate debt, currently at three years and thus consider facilitation of development of a market mechanism that makes available flow of IF to CDs under CIRP.

17. Under the circumstances, the issues for deliberations:

a. Should IF be restricted to a minimum amount required for carrying on operations and not to expand capacity utilization, considering the remit of the Code?
b. Are the current provisions in law adequate to make IF available for CDs under CIRP;
c. How can a deep, liquid market for IF be developed and deepened?
d. Is there a need for a special situation fund?
e. Should Alternative Investment Funds registered with SEBI be facilitated to provide IF?
f. What safeguards are required to ensure that IF is not used for ever-greening or otherwise misused?
g. What safeguards are required to protect the interests of providers of IF?
h. Should IUs, NSE and BSE be encouraged to provide a platform for raising IF?

Preventing misuse of interim finance is the remit of the CoC. The joint vigilance of the Resolution Professional (RP) and the Committee of Creditors (CoC) is necessary to prevent the problem.

C. Market for liquidation assets.

18. The Code combines in a single legislation, the processes for resolution or liquidation of corporate person. In cases where resolution is not possible, an insolvent CD needs to exit with least disruption and cost and release the idle resources in an orderly manner for fresh allocation to efficient uses, based on their priority of the claims.

19. The Code and regulations made thereunder for liquidation provide details of procedures to be reckoned to start with issue of liquidation order under Section 33 of the Code till dissolution order under Section 54 (i.e. Chapter III of Part II of IBC). The provisions governing liquidation offer a comprehensive strategy to implement the process of liquidation. Liquidator is the Insolvency Professional who attempts to evaluate and realise the assets of the company to ease the process of liquidation.

20. The Code empowers the liquidator to sell the immovable and movable property and actionable claims of the CD in liquidation by public auction or private contract, with power to transfer such property to any person or body corporate, or to sell the same in parcels. The regulation enables the liquidator to (a) sell an asset on a standalone basis; or (b) sell the assets in a slump sale, a set of assets collectively, or the assets in parcels. The liquidator shall ordinarily sell the assets of the CD through an auction and may sell the assets of the CD by means of private sale in certain circumstances

21. This require an efficient market, including participants and platforms for sale of assets during liquidation. There is therefore a need to create a specialized asset sale platform. Previous liquidation regimes were reportedly undermined by cartelisation. Care needs to be taken to ensure that transparent processes, including e-auctions, help address this problem. Besides, promoters, who are wilful defaulters, are also barred from repurchasing the firm's assets under the Insolvency and Bankruptcy (Amendment) Act, 2017. However, the legislative intent is clearly that there should be as many bidders as possible, and that the promoter is free to bid, if otherwise not ineligible.

22. Regulation 33 of the Code relates to mode of sale and provides that the liquidator shall ordinarily sell the assets of the corporate debtor through an auction in the manner specified in Schedule I. Clause 7 of Schedule I states that the liquidator shall sell the assets through an electronic auction on an online portal, if any, designated by the Board, where the interested buyers can register, bid and receive confirmation of the acceptance of their bid online. It is therefore proposed that IBBI may facilitate auction platform.

D. Markets infrastructure for facilitation of transactions under the Code

23. The desirable market infrastructure is expected to cater to three markets discussed in earlier paragraphs as under:

(i) Market for resolution plan (including virtual data rooms)
(ii) Market for interim finance
(iii) Market for liquidation assets

24. The market infrastructure may be capable of catering to all the three services keeping in view the following issues:

(i) Cost of the platform, the intermediation fee

(ii) Central counterparty role for risk mitigation through novation

(iii) The eligibility conditions laid down by IBBI

(iv) Ensuring competition in market

25. There is no formal market place where the assets of the CDs, particularly specialised equipment or high value assets, can be bought and sold conveniently. Notwithstanding the economic principles 'supply creates its own demand' and 'everything sells if price is right', development of market for any asset needs facilitation at least in the initial days. It is necessary to facilitate development of a market mechanism which enables competing bids to buy assets and the sale of the asset to the highest bidder, the objective being the highest realisation for the stakeholders.There is need to create market for stressed assets**.**

26. In pursuance of this need, the Board scheduled a meeting of liquidators handling cases under the IBBI (Liquidation Process) Regulations, 2016 wherein it was clarified that presently, they are using different platforms of e-auction for sale of assets. These include bankauction.in, bank-auction set up by Tender Wizard under the DRT/SARFAESI provisions, Auction Tiger.net formulated by different service providers established pan India. A general consensus emerged that establishment of a single centralised e-auction platform would provide a credible and authenticated system and also facilitation e-auction can be carried smoothly.

27. Market players, who provide asset auction platforms and satisfy certain eligibility criteria, can be empanelled for asset auctions. International auction platforms with high credibility may be approached. There is a need to create a specialized asset sale platform to ensure uniformity and transparency to the auction process.

28. The Board has earlier taken up the issue of auction with MSTC, a Government of India PSU. However, it could not be taken forward on account of higher intermediation fee. National e-Governance Services Ltd (NeSL), the first Information Utility registered under the Insolvency and Bankruptcy Code has shown interest in the providing such a platform stating that they can play additional roles and provide value added services to the stakeholders in the insolvency process, to create a greater eco-system of solutions using information technology, while at the same time bring transparency in the insolvency and bankruptcy processes,

including the liquidation process thereby making the resolution process efficient and seamless. It showcased the proposed overall e-auction structure of the platform including the registration process, listing of assets, basic work flow, steps for surveillance, risk/fund management, players and their role in the process, manner of the financial structure/cash movement, etc. The rules and standards may have to be laid down involving the terms and conditions of the sale process which includes, total time of bidding process, extension of time of bidding process in case of inter-se bidding, the notice period, fixation of amount of deposit of earnest deposit and the reserve price, release of payment consideration, format for advertisement of sale notice and tender document etc., standards for due diligence of the prospective bidders, requirement for physical verification of the assets by the prospective bidders, standards for monitoring of whole sale process and security system. Allowing the IU to provide ancillary services in addition to its core services is likely to provide it with better revenues and hence ensure its continuous profitable engagement.

29. BSE Ltd. (BSE) has also shown its interest in being able to provide a platform for stressed assets and given the years of experience in handling such platforms. The advantage with BSE is that they have proven track record of over 100 years and their turnaround time for delivery of the services may be low. It made a presentation of its capability towards this on 6thMarch, 2018. It also has the capacity to deliver to the ecosystem the virtual data room, costing foreign exchange to the insolvency process transactions, will have the benefit of saving foreign exchange.

30. The Governing Board may like to consider the proposal for creating market infrastructure. IBBI may come up with eligibility criteria for providers of market infrastructure. To begin with, IBBI may aim at engaging with regulated entities providing market infrastructure and IBBI regulated entities.

Annexure-A

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Sweet Melody Of Distressed Assets

The first large resolution asset goes for a song

The first resolution of a large non-performing asset has taken place under the Insolvency and Bankruptcy Code, with Monnet Ispat, which has an integrated steel plant facility of 1.5 MMTPA and owes lenders ₹10,237 crore, being sold to JSW in partnership with two private equity firms. The buyers will pay off ₹2,450 crore of debt, acquire 75% of the company's equity for ₹875 crore upfront and another ₹200 crore in the future, and acquire control over steel assets whose replacement cost would be over ₹12,000 crore. This entails a drastic haircut for banks, of about 67%, which will come down by the future worth of the 18% stake the lenders retain in the company under JSW's operational control. The buyers will acquire the plant for just ₹1,075 crore and some ₹2,500 crore of debt on the acquired company's books. Clearly, deeper markets are needed for distressed assets.

Similar deals in insolvency resolution cannot be ruled out, with steel and power assets being sold off at a fraction of the cost of setting up new capacity. This would be a windfall for the acquirers and release from the shackles of non-performing assets for the banks but a huge burden on the taxpayer to recapitalise the banks to provide for the haircuts they take. Greater competition in the bidding for the distressed asset would lower the haircuts for creditors. There would be two benefits to bringing retirement funds such as the Employees Provident Fund and the National Pension System into play as holders of special situation funds that take part in the bidding for distressed assets. One, the increased competition would raise the price of the distressed assets on sale and reduce the haircut; and two, the gains the acquirers of assets at a steep discount to the replacement cost make would be shared widely among the public.

The resolution of bad loans cleans up bank books and lets them lend afresh for infrastructure projects. This, in turn, will add momentum to economic growth. Resolution of bad loans even with steep haircuts is better than no resolution. Small haircuts would be even better.

Annexure -B

Highest Bidder Right Choice Under IBC

Widen the market for distressed assets, though

The government has done the right thing by instructing public sector banks to go by the value of the bid while assessing alternate offers for buying out distressed assets offered for sale as part of the resolution of loans gone sour under the Insolvency and Bankruptcy Code (IBC). The highest price on offer for the resolution asset serves the public interest best in multiple ways. One, it minimises the haircut the banks have to take and, thereby, minimises erosion of lending capacity that has to be made good via recapitalisation of the banks using taxpayer money — from the point of view of public finance, accepting the highest bid is the right choice. Two, it is the fairest and most transparent criterion by which to determine which among the alternative offers for a particular asset is successful. And, three, it is best for the optimal utilisation of the assets being sold.

Any company represents a combination of resources — people, skills, capital, machinery, vision, ambition, brand, goodwill — each of which has value in itself but can produce value in excess of their sum when operated together as a company. A company's valuation reflects its ability to produce value, and will be the present value of future income streams. The higher the value, the greater the implied productive potential of a company. A functional market for corporate control will, in theory, ensure that the company keeps producing optimal value: if its performance is suboptimal, someone would find it worthwhile to take it over at a price superior to its current value, and make it run better. The same logic applies when the company is sold at a distressed asset as well. Whoever pays the highest price for those assets will get them to generate the most income. The highest bidder is the right choice from the point of view of the highest bidder, as well.

Who gets to bid for the distressed assets is vital. Keeping anyone out is suboptimal. The effort should be to widen the market for distressed assets, encouraging public retirement saving trusts to take part along with private equity players.