

## Role of IBC in economic growth

1. In his famous theory of economic development, Austrian economist Schumpeter coined the term creative destruction as the “*process of industrial mutation that incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one.*”

2. This process of creative destruction, uniquely embodied in Hinduism as the Nataraja form of Lord Shiva, shows that creative forces need not be generative alone. The IBC and its work for the economy can be surmised as a continuous process of creative destruction, which will, in turn, propel economic growth for the nation.

### The primary goal of IBC is resolution, not recovery

3. The quality barometer for judging the IBC should be its ability to resolve corporate stress in cases where the continuation value from company operations exceeds the liquidation value. Thus, a well-functioning bankruptcy resolution system will minimise the costs of liquidation, i.e., re-deploying specialised assets and the loss of valuable organisational capital.

4. For most countries, bankruptcy resolution is more of an exception than the norm. Often, bankruptcy laws are historically developed to liquidate failed businesses and are slow to resolve financial distress for viable companies, as restructuring involves more information gathering, financial analyses, operational expertise, and coordination.

5. While the direct approach is important, the nuanced approach of resolution is where the mettle of bankruptcy institutions truly shines.

6. Looking at eight years of IBC from the resolution perspective, the reform has significantly altered the bankruptcy landscape in India. Data from the Insolvency and Bankruptcy Board of India (IBBI) shows that creditors have, on average, realised 32 per cent of the admitted claims and 168 per cent of the liquidation value in cases resolved under IBC. A 2023 study by IIM-Ahmedabad further reveals that:

- Average sales of previously distressed firms increased 76% in three years since resolution. While the net margins remained negative, the resolved firms have operationally broken even in the post-resolution period.
- There is a 50 per cent increase in the average employee expenses in the three years post-resolution—indicating a higher employment intensity in the resolved firms (listed) in the post-resolution period. The total employment across listed firms has also shown a substantial increase in the post-resolution period.

- Liquidity has improved in the post-resolution period by about 80 per cent. The trends indicate a significant increase in the liquidity of the resolved firms in the post-resolution period. For instance, the current assets to current liability have improved from 1.01 in the year of bankruptcy to 1.83 in the third-year post-resolution
- Market capitalisation of listed resolved firms indicates a significant revival in the average market valuations in the post-resolution period. A similar trend is seen for the aggregate market valuation of all the resolved firms, which increased from around Rs 2 lakh crore to Rs 6 lakh crore in the post-resolution phase. Thus, the results suggest that the market has priced and acknowledged the potential of these firms in the post-resolution period.
- Survey participants were largely satisfied with the resolution process and exuded confidence in their ability to meet the projected

#### An orderly resolution framework will tether the volatility of India's credit cycles

7. Using data on bankruptcy efficiency and business credit across 39 countries, a recent NBER paper<sup>1</sup> documents that business credit booms are followed by severe economic contractions in environments with poorly functioning business bankruptcies. They find that following a 10-percentage point increase in business credit to GDP over the past five years, output in the next five years declines by around three percentage points if bankruptcy efficiency is at the bottom quartile. They also observe substantial declines in investment and consumption and increases in unemployment in countries with low bankruptcy efficiency but to a limited extent in countries with high bankruptcy efficiency. On the contrary, in settings with well-functioning business bankruptcy, the aftermath of credit booms is characterised by moderate changes in output, investment, and unemployment.

#### Bankruptcy reform and credit cycles – the case of Japan<sup>2</sup>

8. Japan's experience vividly demonstrates the significance of bankruptcy institutions in credit cycles during the last two decades of the 20th century. Until the late 1990s, Japan's bankruptcy institutions were underdeveloped and characterised by a slow process focused on liquidation. Business lending in Japan had traditionally depended heavily on real estate, leading to a sharp credit boom when property prices surged in the late 1980s. However, the boom ended with the collapse of real estate prices, resulting in severe negative macroeconomic effects.

9. The inefficient bankruptcy system made it difficult to resolve bad debt, leaving firms burdened by debt overhang and banks struggling with nonperforming loans, often resorting to evergreening such loans due to the cumbersome default resolution process. These issues intensified credit contractions, resource misallocation, and economic downturns. As bad debt problems

<sup>1</sup> <https://www.nber.org/system/files/chapters/c14994/c14994.pdf>

<sup>2</sup> Material paraphrased from <https://www.nber.org/system/files/chapters/c14994/c14994.pdf>

worsened, Japanese policymakers acknowledged the critical role of bankruptcy institutions and initiated major reforms from 1996 to 2005.

#### IBC acts as a systemic benefit through multiple channels

10. An immediate impact of the IBC has been to solve the twin balance sheet problem of banks and corporates. The IBC has rescued 3293 corporate debtors till June 2024. About 1005 corporate insolvency resolution processes have yielded resolution by the end of June 2024, taking an average of 571 days to conclude. There are over 4400 insolvency professionals registered as of June 2024. Inevitably, the IBC also has generated system benefits in other areas of the economy. Below, some key research findings of the ripple effects of the IBC have been listed:

11. FX hedging by firms – Research shows that currency mismatches in the corporate sector have reduced after India’s bankruptcy reform. BIS research<sup>3</sup> from 2018 showed that the probability of the treated group of firms hedging currency exposures increased relative to the years before the law changed. The likelihood of firms with a high degree of currency mismatch issuing ECB loans on a fully hedged basis went up by 13.7% following the introduction of the new bankruptcy law.

12. Reducing bond credit spreads – Dr Rajeshwari Sengupta and Harsh Vardhan<sup>4</sup> find that the IBC lowered the credit spreads for bonds issued by non-financial firms in the period from 2016-17 to 2019-20 compared to the bonds issued by the finance firms in the years 2014-15 and 2015-16, especially when other issue-level determinants of credit spreads are taken into account. An effective bankruptcy resolution regime is critical for bond investors to develop confidence in the Indian market. Currently, the bond market is skewed towards high-rated (AAA and AA) bonds, which account for more than 85% of all issuances. To develop a deep and liquid market for lower-rated bonds, investor confidence in effective bankruptcy resolution will be crucial.

13. Exports – Research findings<sup>5</sup> for a large sample of 4434 firms between 2000 and 2020 suggests that exporting firms in India have benefitted from the bankruptcy reform law by helping them better access credit and get out of financial constraints.

#### Bankruptcy reform is a continuous process

14. Bankruptcy efficiency is higher if the viable company can continue to operate and the procedure does not take too long or incur too many costs. Essentially, restructuring and insolvency services need to be prepared to ensure companies can fail well and fast.

15. It is also important to note that the extent of creditor recovery does not reflect the efficiency of insolvency services. About five years ago, Orchid Healthcare Ltd and Ghotaringa Minerals Limited caught media attention when it came to light that they owed Rs 8163 crores to creditors

<sup>3</sup> [https://www.bis.org/publ/bppdf/bispap96\\_c\\_rh.pdf](https://www.bis.org/publ/bppdf/bispap96_c_rh.pdf)

<sup>4</sup> <http://www.igidr.ac.in/pdf/publication/WP-2023-001.pdf>

<sup>5</sup> <https://idsk.edu.in/wp-content/uploads/2022/06/OP-76.pdf>

with absolutely no assets when they entered the IBC process. On the contrary, two other companies, Binani Cements and MBL Infrastructure, yielded a one hundred per cent recovery.

16. The contrast between creditor recoveries for these companies reveals that recovery only reflects the extent of value erosion by the time the companies entered the resolution process. In general, recoveries are influenced by several factors, including the nature of the business, business cycles and market sentiments.

17. The next step towards bankruptcy reform is to improve operational efficiencies to speed up the resolution process. This is especially important for MSMEs, for whom legal costs can prove to be substantial. Improving time efficiencies in the system comes down to using innovative resolution routes such as the pre-pack arrangements for MSMEs, inter-disciplinary capacity building of resolution professionals across legal, financial and industry basics and minimising judiciary delays in proceedings.

18. Operational efficiencies require a balancing act between fairness and fastness of resolution. While institutional infrastructure must improve to perform this balancing act better, creditors' trust in debtors must also be enhanced. A behavioural change in the attitude of promoters is significant in enhancing this trust.

#### Concluding thoughts

20. Macroprudential tools are handy for muting the effects of credit cycles. However, a good bankruptcy regime is a backstop during downswings, reducing the need for costly macroprudential interventions.

21. A continuously evolving and improving IBC framework is important to achieving a 7-8 per cent growth over the next decade. India's growth aspirations require capital to operate at the frontiers of productivity and efficiency. An efficient bankruptcy system will free up capital, allowing better production, employment and growth prospects.