

From Chairperson's Desk

Insolvency Reform: Developing Metrics, Tracking Outcomes

The question that I have been asked the most is: "How do you assess outcomes of the Insolvency and Bankruptcy Code, 2016 (Code)?" The questioner often does not expect a professional response, but a validation of his own assessment. He has assessed the outcome based on his own perception of a transaction value, a process flow, a design feature, an implementation issue, a deviation from expectation, a comparison with the erstwhile regimes, etc. depending on his exposure, caliber, interests, and ideological inclination.

Every economic reform, including insolvency reform, does somewhat recast the rules of the game for market participants with a view to increase overall economic wellbeing. As such, it may affect interests of participants differently: some may stand to gain while others may lose, as compared to the old order. It is unlikely that a loser or a gainer, who is generally blinded by his self-interest, will use a metric that holistically and objectively assesses outcome of the reform. He tends to cite purposive examples to buttress his perspective. A beneficiary of the old order, for example, may cite the likes of Ghotaringa Mineral Limited and Orchid Healthcare Private Limited to cry foul of the insolvency reform. He may claim that insolvency proceedings of these two companies under the Code realised precious little for creditors as against their claims of a few thousand crore rupees. He may not, however, posit that these companies had absolutely no assets when they entered the insolvency proceedings. Thus, the choice of metric depends on which side of the table the participant sits.

A dispassionate analyst, who looks at the reform from a macro perspective, is likely to use a metric that is readily available, easily understood, and amenable to analysis, rather than what is the most appropriate. Authentic figures about recovery through insolvency proceedings are readily available. Recovery, both in absolute and relative sense, is easily understood. It can be used to compare resolution of one company with that of another, or to compare different options for resolution and recovery. Some analysts may prefer to use recovery as a metric to assess the outcome as a matter of convenience, even though it is not an objective of insolvency reform, and it arises only as a by-product of the insolvency proceedings. Time taken for closure of an insolvency proceedings is another convenient metric. An optimist analyst may observe time taken under the Code as compared to that under erstwhile regimes, while a passionate critic may focus on the gap between time taken and the time envisaged under the Code.

Some of the convenience metrics could be misleading. Recovery, though a precise metric, is not unambiguous. The resolution plans under the Code recover, on an average, about X% of admitted claims of creditors. Such level of recovery could be good for someone as, of the available options, it recovers the best. This may not be so good for another, as it entails a haircut of Y% for creditors. Further, recovery as a percentage of admitted claim, which most often is not in sync with the reality, may not make much sense. What could be realised is reflected by liquidation value of the assets available in the books of the debtor. What should be realised is reflected by the written down value of the debt in the books of the creditor. Recovery as compared to what should or could be realised presents a picture entirely different from X% or Y%.

A student of law and economics looks at insolvency reform from a much deeper perspective. He believes that every economic actor has bounded rationality and cannot anticipate all possible contingencies. It enters into contracts, and renegotiates and modifies its terms, as and when circumstances change, and yet every contract at any point of time remains an incomplete one, with gaps and missing provisions. Nobel laureate in Economic Sciences, Mr. Oliver D. Hart argues that a firm enters into a series of incomplete contracts which allow every creditor foreclosure rights over firm's assets in lieu of credit. Every creditor feels comfortable on standalone basis and the firm meets commitment towards each creditor in normal course and the life goes on. However, when the firm is stressed, it can honour claims of one or a few creditors fully, but not all creditors simultaneously. It is a situation where claim of an individual creditor is consistent, but claims of all creditors together is inconsistent, with the

assets of the firm. If every creditor sticks to its pre-insolvency rights, neither resolution of stress is possible nor can a creditor realise its dues.

The insolvency framework endeavours to resolve such a stress while discharging obligations towards creditors to the extent realistically possible under the circumstances. Insolvency reform is thus an overarching contract, that completes all incomplete bilateral and multilateral contracts, makes claims of all creditors consistent and prevents a value reducing run on the assets of the firm and thereby tries to rescue the debtor and creditors. But for the overarching contract, the parties would enforce a series of incomplete contracts, which may wipe out the debtor and write off some creditors. A student of economics may find a metric in the lives of the debtors rescued, the loss avoided to creditors and improved capacity utilisation. Where contract enforcement takes years as compared to time bound closure of insolvency proceedings, the time saved in contract enforcement may serve as the metric for a student of law. Given that contract enforcement is fundamental to markets, a policy maker may consider improvement in ease of doing business and consequently economic development as the metric.

Economies compete to make the environment easier for doing business. It is easier to do business in an economy, which provides, protects and enforces economic freedom at marketplace. Freedom is paramount for a businessman. He needs freedom to start a business whenever he finds an opportunity, freedom to compete at marketplace, and freedom to exit when the business fails. He typically commences a business when he has the reassurance of exit in case of failure. He may fail when he becomes a victim of Schumpeter's "gale of creative destruction", where his business is failing to earn normal profits, either because it is outdated or the space is overcrowded. Higher the intensity of competition and innovation in an economy, higher is the rate of failure, higher is the incidence of sunrise businesses replacing the sunset ones, and higher is the need for freedom to exit. An honest businessman uses the degree and quality of freedom to exit from business as the metric to assess the outcome of insolvency reform.

We are familiar with the parable of the blind men and an elephant, where each of the seven blind men describes an elephant based on his own limited experience. Like the description of an elephant by one person, a single metric may fail to adequately capture the outcome of insolvency reform. The World Bank Doing Business Report uses a composite metric, which studies the time, cost and recovery of insolvency proceedings and strength of the insolvency framework to arrive at a score for resolving insolvency for an economy. It has its limitations given that the methodology has been drawn up to cater to about 200 countries, each of which has had a unique experience in the insolvency outcomes.

A single metric or a composite metric often does not capture softer aspects such as humanitarian approach while dealing with insolvency, or invisible outcomes in terms of behavioural changes of stakeholders. They generally do not capture the systemic gains such as induced resolutions outside the Code, liberation of entrepreneurs from failure, rescue of companies in deep distress, release of idle resources for productive uses, and meritocratic lending and improved availability of credit. It is because a metric tends to capture what can be measured and it ignores the matters that cannot be measured even if they matter. As Elliot Eisner puts: "Not everything that matters can be measured, and not everything can be measured matters."

A well laid metric, instead of or in addition to measuring outcomes, may influence the outcome. In other words, when we set one parameter as a measure of outcome, there is a tendency to achieve the same, and even game the same, overlooking other equally, or even more important aspects and dimensions of the outcomes. Goodhart's Law cautions: "When a measure becomes a target, it ceases to be a good measure."

A metric is not a onetime affair. After it is conceptualised and its methodology finalised, it needs to be nurtured for years with appropriate modifications with changing times and evolving practices. Systems need to be in place to generate the metric with suitable frequency. Provisions need

to be made for feeding authentic data and information for servicing the metric. In different spheres, specialised organisations have come up to maintain and service different metrics. It is the time to sow the seeds of a sound metric(s) for tracking the outcomes of insolvency reform when it is taking deeper roots in the country. The metric(s) should holistically and objectively measure the outcome, involving evaluation of the structure, processes and designs of the market contributing to the fairness, integrity and credibility of the market in each of the segments, namely, corporate insolvency and liquidation, and individual insolvency and bankruptcy. If no guidance is available as to what is an appropriate metric, and there is no provision of data / information to service such a metric, the market may use any convenience metrics, which may do more harm than good to the cause of insolvency reform.

While encouraging debate on development of metrics, the scholars may explore metrics to measure outcomes of the Code around its six foundational objectives. These are: (a) resolution of stress; (b) maximisation of value of assets; (c) promoting entrepreneurship; (d) enhancing availability of credit; (e) balancing of interests of all stakeholders; and (f) establishing an ecosystem. These objectives can be translated into six possible layers of outcomes of an insolvency and bankruptcy regime:

(a) The growth, strength and efficiency of the **insolvency ecosystem** consisting of insolvency professionals, insolvency professional agencies,

insolvency professional entities, registered valuers, registered valuer organisations, information utilities, Adjudicating Authority, Appellate Tribunal, IBBI, Government, Courts, etc.;

(b) The strength, efficiency, and efficacy of **the processes**, namely, corporate insolvency resolution, corporate liquidation, voluntary liquidation, pre-packaged insolvency resolution, fresh start process, resolution of personal guarantors to corporate debtors, resolution of proprietorship and partnership firms, individual insolvency resolution, bankruptcy, etc.;

(c) The growth and efficiency of **markets** such as markets for interim finance, resolution plans, liquidation assets, insolvency services, along with cost efficiency, information efficiency, etc.;

(d) The impact **on businesses** in terms of cost of capital, capital structure, availability of credit, entrepreneurship, capacity utilisation, creative destruction, competition, innovation, etc.;

(e) **Behavioural changes** amongst the debtors and creditors, trust of the creditors in debtors, meritocratic lending, non-observable impact, humanitarian considerations, proactive/ preventive impact of the Code, etc. and

(f) The **overall impact** on employment, income and economic growth of the nation.

Table below lists these layers of outcomes and possible indicators for tracking them.

Layer of Outcome	Objective	Indicator
Strength of insolvency ecosystem	To aid the processes in pursuit of objectives of the Code	- Strength of each of the elements of the ecosystem. - Performance of each of these elements.
Strength of insolvency processes	To aid stakeholders to pursue the objectives of the Code	- Use of the processes under the Code by creditors and debtors as compared to other available options. - Efficiency of the processes in terms of cost-time-recovery framework.
Strength of insolvency markets	To aid the insolvency processes to arrive at competitive market outcomes	- Availability of interim finance. - Availability of competitive resolution plans. - Cost and information efficiency of the markets.
Impact on businesses	Enhance availability of credit, promote entrepreneurship, drive competition and innovation	- Impact on cost of capital. - Change in capital structure of firms. - Impact on availability of credit. - Entrepreneurship culture in the economy.
Behavioural changes	Desired behaviour through incentives and disincentives	- Proactive / preventive resolutions. - Resolutions in the shadow of or on account of the Code. - Settlements during resolution process. - Meritocratic / cleaner lending.
Overall impact	Improvement in corporate governance, resource allocation, and economic growth	- Employment saved because of resolution of distressed companies. - Amount of recoveries by creditors being ploughed back into the credit cycle. - Capacity utilisation and resource allocation. - Impact on economic growth of the country.

Usually, the data necessary to build metrics for assessing the outcomes of an insolvency regime are scattered and challenging given the dynamics of the market. Given that India's insolvency regime is still nascent and unique, data systems in respect of insolvency are just emerging. The importance of having an *ex-ante* strategy for *ex-post* evaluation highlights the data requirements of the evaluation and, by doing so, allows early collection of the necessary information. The time is ripe to harness the data being generated under the Code and decipher measurable impacts of the Code. It is imperative to have a clearly defined framework of indicators to monitor and measure outcomes of the Code that are tracked and reported on a regular basis against the objectives/ benchmarks. It should be strengthened with an institutional arrangement to steer generation and dissemination of relevant data and encourage useful research in matters of policy design and implementation. It will

facilitate informed public debate on policies and thereby help in crowdsourcing of ideas for good policy response. Data driven analysis will not only enrich the policymaker's toolkit for sound policy making, that have a direct bearing on the beneficiaries or stakeholders of the Code but will also be useful for other purposes like supervision of banks and financial institutions, monitoring of financial systems, or general macroeconomic models.

Developing metrics and tracking the outcome of a complex policy-institutional change is not an easy task, unlike in the case of projects or programmes. It is necessary to develop a dynamic multivariate metric, which uses both quantitative and qualitative tools, to capture the outcomes of a poly-centric insolvency reform.

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