

Information Utilities: Mitigating Asymmetries

“Often the main problem is that borrowers are more alert of pitfalls of financial contract since they are better aware of the risks involved in a project for which financing is requested. These informational differences are the very underlying cause of adverse selection or what is already known as the lemons problem....”

Domantas Skardziukas

Information asymmetry is the situation where one party in a transaction is better informed in comparison to the other party. Such situations tilt the balance of power in favour of the party having the information at the expense of other who goes for financial contract without gauging the market pulse. In situations of financial distress, information asymmetry arises as the corporate debtor - its shareholders and promoters, are better informed of the asset value than the creditors. Incomplete or missing information delays decision making, exacerbates value erosion and increases the costs associated with re-organisation of the firm. It may also lead to sub-optimal decisions regarding viability of the business or the feasibility of a resolution plan. Value erosion is critical in deciding the revival prospects of the debtor and is detrimental to both the debtor and creditor and needs to be minimized in order to achieve the objective of value maximization through resolution.

Information asymmetry is addressed with incentives to encourage disclosure of information; to provide for disclosure through statutory mandate; through use of an ‘information intermediary’ to gather and share information between stakeholders, and monitoring of disclosure with rewards/penalties associated with performance in this regard. The development of information intermediary institutions has been a pre-dominant means, as it systematises the addressing of the concern of asymmetry and is able to carry out regular monitoring and adapt to changes in market conditions.

The financial sector evolved institutions of market intermediaries like financial analysts, rating agencies etc., alongwith statutory mandates on businesses through listing disclosures and obligations to reduce information asymmetry. These measures have enabled better flow of information between creditors and debtors and, larger market investors, helping reduce the cost of information asymmetry. There are multiple institutions collecting “financial information” and “credit information” in the economy, collectively known as the “credit information companies” (CICs) which are

regulated by the Reserve Bank of India. Further, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) was amended in 2016 to provide for a central database to integrate records of “property” registered under various registration systems with the central registry. The Insolvency and Bankruptcy Code, 2016 (IBC / Code) has experimented with a unique dispensation, unheard in other jurisdictions, which provides for Information Utilities (IU) as a means to address the concern of information asymmetry.

In 2015, the Bankruptcy Law Reforms Committee (BLRC) in its report on rationale and design, laid out the essence of IU and need for the same.¹ Post the insolvency filing and before the commencement of the resolution process, an essential step is to correctly establish the facts on the assets available, who the claimants are, and what contracts are in force. The prime motivation was to establish an institution in the form of an IU that can act as a storehouse of crucial debt and default information. The IU was designed as an institution with multiple objectives, namely:- (i) undisputed information for initiation of insolvency process; (ii) a credit and contract repository; and (iii) repository of authenticated financial information verified by all parties of the debt.² It was also to function in a private competitive market to avoid creation of a monopoly and minimised the chances of market failure by mandating that IUs were to be interoperable. It was envisaged that over time, IUs would collectively capture a comprehensive picture of the financial liabilities of all entities. BLRC further recommended leveraging technology to build the IU. The IBBI registered the first IU namely, National E-Governance Services Limited (NeSL) on September 25, 2017. The entity is promoted by State Bank of India, Canara Bank, Bank of Baroda and others.

The IBBI (Information Utilities) Regulations, 2017 (IU Regulations) enable the IBBI to lay down technical standards, through guidelines, for the performance of core services and other services by IUs, based on the recommendations of a Technical

Committee. The technical standards ensure reliability, confidentiality, and security of financial information to be stored by the IUs. Based on the recommendations of the Technical Committee, the IBBI laid down technical standards on December 13, 2017. These standards relate to terms of service; registration of users; unique identifier for each record and each user; submission of information; identification and verification of persons; authentication of information; verification of information; data integrity; consent framework for providing access to information to third parties; security of the system; security of information; risk management framework; preservation of information; and purging of information.

The RBI amended the Credit Information Companies Regulations, 2006 on August 11, 2017 to include the IU and a Resolution Professional appointed under IBC, as a “specified user” (earlier limited to banks and financial institutions) and allowed them access to the databases of existing CICs. Regulation 26 of the IU Regulations, enables the IU to import information from such registries as may be notified by IBBI. It is expected that the business models and cost structures of IU and CICs permit seamless and cost-efficient flow of information between the two, so that a debt-default may be determined clearly and expeditiously in insolvency matters. The Code emphasises the need for readily available, reliable information in the hands of the creditor and debtor. Section 215 of the Code requires financial creditors to submit financial information to IUs. It also mandates that the information submitted is co-verified with all the concerned parties. As on March 31, 2022, 692 financial creditors and 779 operational creditors have submitted information for around 95 lakh debtors with NeSL. 1.42 crore loan records have been on-boarded so far and defaults in around 3 lakh loans have been authenticated by the debtors.

Time is of essence in the insolvency resolution process and delays in establishing the existence of debt and default amount needs to be reduced. In order to trigger a case of insolvency against an entity, the creditor has to prove that (a) the debtor has a liability to the creditor and (b) its failure to meet such liability. The Code states that creditors have to submit such information along with the application for initiation of insolvency resolution. Without this evidence, the adjudicator will refuse to register the insolvency case, or defer the matter until the same can be proved. Traditionally, the process of establishing debt and default was

paper based and reliability was questionable, requiring extensive enquiry by the Adjudicating Authority (AA), thus leading to delays in initiation of the insolvency process. If, on the other hand, the record of the liability and the instance of default is readily accessible from an IU then the time taken for admission can be reduced.

Enhancing effectiveness of IU

The Standing Committee on Finance in its 32nd Report³ noted that one of the main reasons for delay in the insolvency resolution process is delay in admission of applications by the AA. The delay in admission of application causes asset erosion. Asset erosion can lower the perceived value of the business, as it lowers the book value of the assets associated with the company which is detrimental to the interests of the stakeholders. It also impacts the investors’ interest thereby increasing the possibility of pushing a viable entity into liquidation. As per IBC, the admission process should ordinarily be completed within fourteen days from the date of filing application. However, there are large delays in admission of applications. While there are several factors leading to such delays such as litigations by the creditors on account of existence of disputes, technical faults in the applications, jurisdictions of AA or lack of adequate capacity at AA, an avoidable factor is the information asymmetry in the entire process which can be mitigated by enhancing the effectiveness of IU.

To address the issue of delays in admission of insolvency petitions, the IBBI solicited views of stakeholders on suggestions to enhance effectiveness of IU, through discussion paper released on April 8, 2022. The paper proposes to streamline the format of information of debt/default, record of default and to facilitate submission of additional information by creditors with the IBBI at the time of filing the insolvency application. The proposals are expected to reduce the information asymmetry for creditors at the filing stage thereby helping to speed up admission and also aid in swifter verification of claims by the insolvency professional. The existing framework along with the proposed changes will further enable seamless information exchange between stakeholders and modernise IU operations and functioning. This would create an information-rich environment that will significantly reduce practical frictions that has, and would otherwise, bedevil the resolution of insolvency and bankruptcy in India.

(Ravi Mital)

¹ https://ibbi.gov.in/BLRCReportVolI_04I12015.pdf

² <https://www.ibbi.gov.in/wg-04report.pdf> - Working Group on Information Utilities

³ <https://www.ibbi.gov.in/uploads/resources/fc8fd95f0816acc5b6ab9e64c0a892ac.pdf>