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The haircut that never was: Need to factor in whether a loan account had become an NPA while assessing haircut from its resolution under IBC

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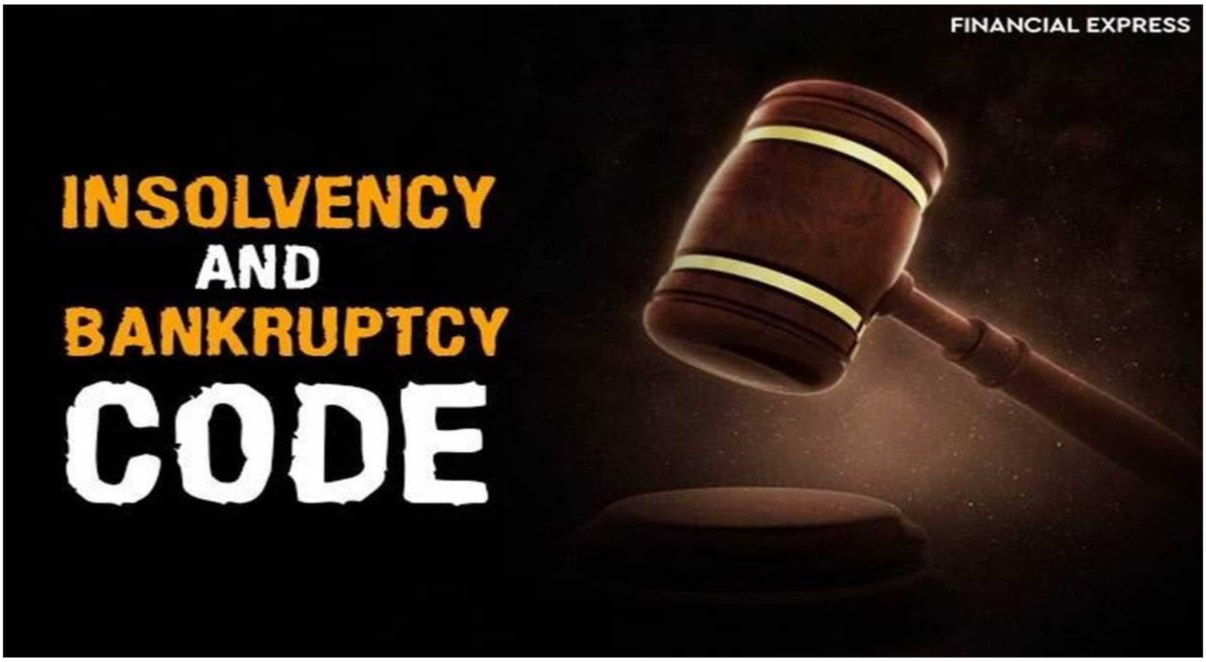

By Debajyoti Ray Chaudhuri

Recently, there have been news reports on 'haircuts' taken by lenders as part of resolution plans approved under the provisions of the Insolvency and Bankruptcy Code (IBC). A haircut, in this context, refers to the shortfall in recovery of the creditors in comparison to their claims submitted before the insolvency professional, as part of the insolvency resolution process of a borrower. One news item even talked about a 'tonsure', referring to the apparent minimal recovery by creditors as a proportion of their claims.

While the haircut quantum, in a few cases, seems very high, it is observed that in many of these cases, insolvency proceedings were initiated after the asset was classified as an NPA in the books of the lender. If an asset is classified as an NPA, it ceases to earn any interest. However, on commencement of insolvency proceedings, notional interest is calculated by the lender on the NPA account and included in the claims. There is nothing wrong in this approach, as an NPA doesn't yield any interest but must be funded by a liability that has a cost. However, this aspect must be considered when assessing the 'haircut', since the recovery of creditors is being calculated as a percentage of the claims, though these have not even been acknowledged by the lender in its balance-sheet.

The concern about the haircut is certainly not misplaced, but this should also have some correlation with the value of the company. The valuation of a company is a function of its goodwill in the market, the customer base it has, its employee strength, proprietary software and workflows, etc. As the stress arising from non-repayment of loans lingers in the company, employees start leaving, customers look for alternate sources, goodwill is lost and, hence, the valuation of a company gradually deteriorates. In the meantime, the liabilities remain the same and, sometimes, even increases if the company is able to access additional loans to meet liquidity issues; the interest burden piles up because of the inability to service the same. So, the haircut—a measure of the shortfall in security compared to the claims of creditors—has already happened, more often than not even before initiation of the insolvency process. Accordingly, some of these assets were not even in the books of the lenders. Insolvency resolution under the IBC has ensured that there is a finality to the process and the residual assets are put to productive use.

A delay in initiating the insolvency process also means that creditors, because of their unhappy experience, are more inclined to take back their money with whatever haircut comes about and make their exit. However, if insolvency resolution is initiated at an early stage, there could be a true resolution, one that could address the reasons for insolvency like obsolete technology, inept management or even over-leveraging. The existing creditors could then stay on and this would give them an opportunity to recoup their haircut in the future via additional business from the company. They could even benefit from the turnaround in fortunes of a company by taking an equity stake. With time, as some resolution plans see successful implementation (as many have), creditors could be emboldened to take this approach.

The IBC has been implemented for less than five years; in five years, a child just learns to find its bearings in the real world. The UK Insolvency Act is of 1986 vintage while in the US the insolvency regime is more than 200 years old. It takes years for a law to settle down and jurisprudence to develop. The analysis of outcomes of the Code has to be done from this perspective, lest there is burnout of the child with the weight of its expectations of its stakeholders.

The author is Chief General Manager, IBBI