

Changing Corporate Credit Culture under IBC



*IBC, 2016 provides a graded response to financial distress of the Corporate Debtor so that the business is run by efficient and performing entrepreneurs. Thus, early diagnosis of financial distress becomes very crucial for which it uses 'default' as an indicator. If promoters can settle the default, CIRP can be discontinued otherwise it moves on to next stage. However, in practice the process is not so straight for economy of the country. The suppliers and vendors of the CD, which act as its lifeline and are generally MSMEs, are often at the receiving end. In this article, the author presents an analysis of the pros and cons of the IBC and makes recommendations to address the concerns of aggrieved stakeholders. **Read on to know more...***



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1. Introduction

You may remember the sufferings of the female lead actress Radha in 1957 epic film – *Mother India*. Why has she suffered? Her husband had borrowed money from a lender for their marriage with a good intention to return it. However, as the crop did not yield expected income, he failed repay the loan. Their inability to repay the loan coupled with greed of the lender and accident of her husband, nothing of which could have been predicted at the time of borrowing, proved disastrous for the family. This story is based on a face-to-face relationship between a lender and his debtor wherein the latter became incapable of returning the money despite his best efforts and the greedy lender rained havoc on them.

However, the relationship between a creditor and debtor becomes highly complex in a corporate setting wherein both creditors and debtors follow a complex corporate culture. It may range from creditor exploiting debtor for repayment of debt to debtor wilfully or tactically avoiding repaying the loan. As the people dealing on behalf of both, financial creditors (banks or financial institutions) as well as the debtors (corporates) are temporary, there may be connivance between them for loans to get commission and



move away leaving the corporate in debt or defunct thereby banks losing the loaned amount forever which is registered by them as NPA (Non-Performing Asset). However, the availability of credit is central to promoting entrepreneurship thereby ensuring industrial growth which is crucial for any economy. This creates the need for a robust banking system for the financial well-being of any economy in the contemporary world.

Banks and other financial institutions collect savings from people and organizations and invest it into big business through various means such as directly lending to corporates and investing in share markets etc. The corporate credit culture comprises all those principals, policies, experience, credit management, strategies, rules & regulations, and risk management etc., which define the lending environment and determine the lending behaviour acceptable to financial creditors. Underlining the scope of credit culture, Y. V. Reddy¹, former Governor, Reserve Bank of India (RBI) said, “the whole issue of credit culture and credit system should encompass the legal and institutional aspect of the policy environment, the way the saver or depositor and the borrower – both small and big are treated and the way banks position themselves to face these challenges”.

The sole objective of this entire corporate credit culture is to ensure flow of credit from financial creditors to corporates and servicing of loan by the debtor with interest rate as per the mutually agreed timeline. What will happen if corporate creditors are unable to repay the loan, which is in thousands of crores, due to business failure or greed or any other reason?

2. IBC's Intervention into Corporate Credit Culture

To fulfil its objectives, IBC provides various insolvency and bankruptcy frameworks wherein the financial creditors get control of the corporate debtors immediately with the commencement of Corporate Insolvency Resolution Process (CIRP). Early detection of default lies at the heart of IBC processes. Therefore, the existence of default is considered as the benchmark for initiation of insolvency processes under the IBC.

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However, if during the CIRP process, the promoter/s of the Corporate Debtor (CD) clears the default, Section 12A of IBC, 2016 provides a provision to withdraw the CIRP application. This provision reveals that the purpose of the IBC is not to dethrone the promoters from the CD but to ensure that the business remains in the hands of efficient and performing entrepreneurs who can repay the loan availed from financial institutions thereby contribute to economic development of the country. Otherwise, the business is considered as failed one and promoters are replaced with more efficient and performing entrepreneurs through a resolution plan following a competitive bidding process. However, if the business is not viable, it is liquidated for release of resources back into the economy.

3. Controlling the Menace of Wilful Defaulters

Before the introduction of liberalization and privatization in 1991, the Indian economy was a closed economy wherein entry into the business was restricted through various licenses and permits. Besides, the expansion of existing business was also controlled by the government through various licenses which is often referred as Licence-Permit-Quota Raj. The various economic and market reforms introduced in the early 1990s ensured availability of credit thereby ensuring free entry of entrepreneurs into the Indian market. However, these reforms soon created the need for another set of reforms to ensure serving of loan by corporate debtors.

¹ Reddy, Y.V. (2004). Credit Policy, Systems and Culture, *Reserve Bank of India Bulletin*, March, p. 311. (<https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/53086.pdf>)

In 1999, RBI introduced the concept of 'wilful defaulters' through 'Master Circular on Wilful Defaulters' presumably to separate promoters who were gaming the system from those who were really facing financial crisis due to one reason or the other. Master Circular's guidelines (as amended till June 30, 2015) to identify 'wilful defaults' included diversion of funds, siphoning of funds, disposal and/ or removal of movable and immovable property from the CD and track record of borrower. "The default to be categorised as wilful must be intentional, deliberate and calculated," read the guidelines².

The number of 'wilful defaulters' in India was 2,469 in FY 2014-15 which drastically dropped to 1254 in FY 2015-16 due to various economic reforms introduced by the Central Government. After introduction of the IBC, 2016, this further dropped to 667 cases in FY 2016-17. This list further decreased to its all-time low to 597 cases in FY 2019-20 but increased to 1063 cases in FY 2020-21 mainly due to economic slowdown caused by Covid-19 pandemic. Thus, the list of 'wilful defaulters' decreased by about 56% in 2020-21 in comparison to FY 2014-15. In this period from 2014 to 2021, the public and private banks collectively recovered about ₹8.01 lakh crore which were classified as NPA and written off loan accounts of wilful defaulters³. Though there may be several factors for decrease in the list of 'wilful defaulters' such strict compliance of financial rules and actions by government agencies particularly Enforcement Directorate, IBC also played a role in financial discipline among the borrowers in the country.

4. Rescuing Corporates Midway- Withdrawal Under Section 12 A

'Your last chance! Clear defaults and get back your business' this message also successfully delivered to promoters while business lies in control of creditors through CoC facilitated by Interim Resolution Professional (IRP) or Resolution Professional (RP). According to the data with IBBI⁴, out of 4,199 cases which were closed by December 2022, 793 were withdrawn and another 611 have been closed on appeal or review or settled. The

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Though Section 12 A has no mention of any time limit for withdrawal of cases, Regulation 30 A (1) of IBBI (CIRP) Regulations 2016 permits withdrawal at two stages (a) before constitution of CoC and (b) before issue of Expression of Interest for Resolution Plan. However, in the matter of *Satyanarayan Malu Vs. SBM Paper Mills Ltd.* (2018), the withdrawal was allowed by NCLT during liquidation process as this most viable option at hand for CD.

5. If Promoters Unable to Get Back Control of the CD

When promoters are not able to get back control of their company, the IBC mandates to search for new entrepreneur/s to run the business. To ensure the CD gets the most capable entrepreneur, the IBC mandates for value maximization before inviting bids for sale through resolution plan. This is done to ensure creditors get back their maximum possible investment/ credit from the CD and the business is saved in the best interest of the economy for it is also linked with the jobs of hundreds and thousands of people. If sale through Resolution Plan becomes impossible, NCLT orders initiation of Liquidation. Here too, the priority is to sale the CD as 'Going Concern'. Liquidation, which is considered as death or dismantling of the CD is always considered as the last option under the IBC. As per the data released by IBBI (IBBI Newsletter, July-Sept. 2022), the performance of IBC at this stage is as follows:

- Till September 2022, 553 CDs were rescued through resolution plans, ₹2.43 lakh crore, which is around 178% of the liquidation value of these CDs.
- Of the 553 CDs rescued under the Code, 97 had admitted claims of more than ₹1,000 crore. Till June

² Master Circular on 'Wilful Defaulters', Reserve Bank of India, June 30, 2015. (https://www.rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=9907#21)

³ The Times of India (2022). Wilful default cases down by over 50% in last eight years: Government Data, March 24 (<https://timesofindia.indiatimes.com/business/india-business/wilful-default-cases-down-by-over-50-in-last-eight-years-govt-data/articleshow/90409785.cms>).

⁴ IBBI Quarterly Newsletter for Jul-September 2022.

⁵ IBC Laws (<https://ibclaw.in/withdrawal-of-cirp-proceeding-pursuant-to-settlement-under-insolvency-and-bankruptcy-code-2016-by-advocate-shivam-jaiswal/>)

2022, 91 such CDs have yielded resolution plans with realisable value of ₹2.17 lakh crore i.e., 184.81% of the liquidation value.

- c) Till September 30, 2022, 18 CDs were closed by sale as a going concern under liquidation process, which realised ₹600.84 crore against liquidation value of ₹527.69 crore.
- d) Furthermore, 1,807 CDs were referred for Liquidation out of which 429 CDs were completed liquidated and assets valued ₹3,306.24 crore were released back into the economy.

6. IBC's Impact on Corporate Credit Culture in India

The insolvency frameworks introduced under the IBC has conveyed the message among debtors that gone are the days when non-paying the loan of banks was considered a luxury. If the promoters don't payback, they shall lose control of the company. The practice of litigation to delay payment of outstanding dues and recoveries by banks and financial institutions under Debt Recovery Tribunal (DRT) have become a matter of past. Under the IBC regime, lenders have a better and faster option of getting their dues from debtors and if required, can take control of the corporate debtor. This has improved corporate credit culture in India and improved financial well being of banks. According to the recent data⁶ Gross NPAs of banks have reduced to ₹7.73 lakh crore as of December 31, 2021, against ₹10.36 crore as of March 31, 2018.

Though recovery is not objective of the IBC, it has proved a better framework for recovery of stressed debt than any previous regime. According to former IBBI Chairperson Dr. M. S. Sahoo "Recovery is neither an objective of the IBC nor even one of the intended benefits"⁷ of the IBC, 2026. According to an estimate in 2019, over ₹5 lakh crores have been the direct and indirect realization on account of the IBC. Out of the total estimated amount about ₹2 lakh crore has been recovered before the cases were admitted for resolution under the Code, while recovery through resolution plans is pegged at over ₹1 lakh crore⁸.

According to the recent data released by the IBBI till December 2022, the IBC has rescued 2298 CDs (611

Till December 2022, 611 CDs were recovered through resolution plans that realised ₹2.53 lakh crore, which is around 176% of the liquidation value of these CDs.

through resolution plans, 894 through appeal or review or settlement and 793 through withdrawal). Besides, 1901 CDs were referred for liquidation. The resolved CDs had assets valued at ₹1.44 lakh crore, while the CDs referred for liquidation had assets valued at ₹0.62 lakh crore when they were admitted to CIRP. Thus, in value terms, around 70% of distressed assets were resolved. Of the CDs sent for liquidation, three-fourth were either sick or defunct and of the firms resolved, one-third were either sick or defunct. Furthermore, the realisable value of the assets available with the 611 CDs rescued, when they entered the CIRP, was only ₹1.44 lakh crore, though they owed ₹8.32 lakh crore to creditors. The Resolution Plans realised ₹2.53 lakh crore, which is around 176% of the liquidation value of these CDs. Any other option of recovery or liquidation would have recovered at best ₹100 minus the cost of recovery/liquidation, while the creditors recovered ₹176 under the Code. The excess recovery of ₹76 is a bonus from the IBC⁹. Besides this direct benefit, the benefits of IBC in terms of economic growth of the country and job creation are huge. This is because any of the recovery-based framework would have caused death/ shut down of some of the corporates leading to job loss, increased unemployment, and social unrest in the country.

The detection of default, which is closely followed up by enforcement agencies of the country has boosted the



⁶ The New Indian Express (2021). 'NPAs down to Rs 7.7 trn due to transparent recognition of stressed assets', March 29 (<https://www.newindianexpress.com/business/2022/mar/29/gross-npas-down-to-rs-773-lakh-crore-due-to-transparent-recognition-of-stressed-assets-sitharaman-2435581.html>).

⁷ Times of India (2021), 'Insolvency law's aim is biz rejig, not recovery', July 05, 2021 (<https://ibbi.gov.in/uploads/resources/dd1ba1872df91985ed1ca4cde2dfe669.pdf>)

⁸ Times of India (2019), 'Dues recovery is not aim of insolvency law', April 01 (<https://timesofindia.indiatimes.com/business/india-business/dues-recovery-is-not-aim-of-insolvency-law/articleshow/68662693.cms>)

⁹ IBBI Newsletter, July-September 2022, p. 19-20.

confidence of investors in the Indian economy which is reflected in the form of Foreign Direct Investment (FDI) and Industrial Growth. As per the government data, the FDI inflows¹⁰ in India has touched a record \$83.57 billion in FY21-22. Despite the recent ups and downs, Asian Development Bank (ADB) has predicted¹¹ 7 per cent GDP growth rate for India in FY 2022-23 and 7.2 per cent in FY 2023-24, which is much higher than Asia's predicted growth of about 4 per cent. These positive signs in Indian economy are due to improvement in the banking system which is a reflection of improving corporate credit culture.

Another evidence of IBC's influence on corporate credit culture comes from number of cases which were settled before commencement of CIRP. According to IBC Newsletter (July-Sept. 2022), till September 2022, at least 23,417 CIRP applications having underlying default of ₹7.31 lakh crore were resolved before their admission by respective NCLTs. This means the defaults of corporate debtors were detected by creditors, but they were settled to avoid CIRP, which involves immediate removal of promoters and hands over the control of the CD to Committee of Creditors (CoC). The number of cases settled before admission of CIRP petitions is about 4 times of 5,893 corporate debtors, which were admitted into CIRP in the same period. In absence of IBC, 2016 a significant number of these corporates would have contributed to the increasing list of wilful defaulters. The fear of losing control on business has sent a right message among the promoters and contributed positively to corporate credit culture.

7. How Corporates can Avoid Financial Distress?

There may be several reasons for a business distress of a corporate some of which can be managed while some other cannot be avoided at all. For instance, a company like Moser Baer India Limited (MBIL), which was manufacturing Optical Storage Media (OSM) devices like CDs, DVDs, and Solid-State Media etc., had no scope of survival as due to technological development its market dried up completely. Finally, it was liquidated.

However, some of the financial distress scenarios can be avoided by better risk management and maintaining

adequate cash flow culture. As distressed assets have a life cycle, the value of company gradually declines with time if distress is not addressed. Therefore, early identification of distress and bringing it before the Adjudicating Authority (NCLT) through CIRP application is very crucial in asset realization. Besides, controlling the menace of PUFET transactions could save several corporates from going into financial distress.

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According to the IBBI data, till June 2022, 786 applications were filed to claw back ₹2,21,104 crore lost through PUFET transactions during the relevant period. If this value was not lost, several of them would not have got into CIRP in the first place. Furthermore, CDs, which ended up with resolution plans through CIRP, had lost ₹41,667 crore through PUFET transactions, accounting for about 4.98% of the amounts claimed against them. In contrast, the CDs that ended up with liquidations had lost ₹1,21,121 crore through PUFET transactions, which accounts for 15.43% of the amounts claimed against them. Data also indicate that CDs getting rescued through CIRP are typically left with assets valued at 17% of the claims when they entered into CIRP. The CDs getting liquidated through CIRP had lost 15% of the claims through irregular transactions and were left with assets valued at 5% of the claims by the time they entered into CIRP. If there was no irregular transaction, these CDs would be left with assets valued at 20% of claims¹². In that case, all of them would be rescued through resolution plans which means better recovery for creditors.

Better supply chain management is another crucial issue. The corporates – small or big, flourish due to a robust management and delicate balance between revenue, expenditure and investment for improvement. A dynamic and vibrant system of supply for raw material as well as human resource plays a crucial role in maintaining this balance and maintain robust cash flow culture in the company.

¹⁰ Ministry of Commerce and Industry
(<https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1826946>)

¹¹ Rediff.com (2022), ADB keeps India's GDP growth unchanged at 7%, December 14 (<https://www.rediff.com/money/report/adb-keeps-indias-gdp-growth-unchanged-at-7/20221214.htm>)

¹² Sahoo, M. S. (2022), PUFET Transactions, *The Resolution Professional*, p. 14-18.

8. Conclusion and Agenda for Discussion

Today, creditors have various options such as bilateral discussions, settlement, restructuring and CIRP to enforce financial discipline on debtors and secure their investment. The Ministry of Corporate Affairs (MCA) is reportedly working to extend Pre-Packaged Insolvency Resolution Process (PPIRP) for big corporates, which will be another option for creditors to ensure safety of their investments. It has created an entirely new profession i.e., Insolvency Profession wherein professionals of various backgrounds including CA, CS, ICWA, Law, Management etc., are drawn to spearhead various processes under the IBC. Besides, IBC has given rise to a new industry i.e., Distressed Financing. Because of the protection provided to the debtors by the IBC, creditors

are coming forward to provide funding to promoters of distressed corporate debtors who have good business prospects.

Though IBC processes are faster than any other previous framework, not meeting timelines prescribed under the Code has been a major concern of stakeholders. According to the recent data with IBBI, 71% of cases were pending for more than 270 days. As the value of corporate debtors deteriorates if the cases are dragged longer, the interest of creditors is also adversely affected and leads to higher haircut which is another major concern of stakeholders. Timeline, haircuts, and value maximization are interrelated. Therefore, an integrated and holistic approach of various stakeholders will be required to enhance effectiveness of the IBC.

