

# A Study on Banking Crises and Insolvency and Bankruptcy code

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## Abstract

The study review surveys theoretical and empirical literature on the causes and outcomes of the banking crisis and summarizes the implementation of insolvency and bankruptcy code to consolidate all laws to insolvency and bankruptcy and to tackle Non-Performing Assets (NPA)—a problem that has been pulling the Indian economy down for years. India needs urgent reforms to its financial system because banks have created a major crisis by lending unwisely to big borrowers who lack the ability or intention to repay their debts. This has made many of loan a non-performing asset (NPA). They are often times characterized by boom-bust cycles in credit and asset prices; and that they are generally resolved through large-scale government interventions. The article concludes with a review that the problem of NPAs in the Indian banking system is one of the foremost problems that had impact the entire banking system. But it is also true that India has carried its banking system to the remotest part of the country and has played crucial role in financial inclusion. It has been successful in creating sound credit and monetary policies keeping development agenda in mind. So, government should pay due regard and attention to this issue for a stable economics and there should be sync between the fiscal and monetary policies of a country with both Finance Ministry and RBI on the same page to achieve the historic 10% growth rate.

**Keywords:** Non Performing Assets (NPA), Bankruptcy, Financial Inclusion , Insolvency Law

## Introduction

The strength of an economy of a country depends on how well jobs are created and sustained in the economy. For the flow to be sustainable, people should have sustainable earning which is provided by their respective jobs. For the jobs to be sustainable there should be good industries and organizations. For all the components in the economy to live in harmony, there should be a sound and solvent financial system. The financial system of an economy can be market based or bank based. The Indian economy is bank based. Hence, welfare of Indian economy depends on the soundness of the banking system. One of the key factors that haunts our economy is the growing Non-Performing Assets (NPA) in the banking system. NPAs not only affect the banking system, they affect the economic growth of the country.

Credit creation for economic activities is the prime function of any Bank. Apart from raising resources through deposits, borrowing, recycling of funds constitute major part of its activity. Lending is encouraged because it helps the economy to expand. However the process carries a risk called the credit risk which may arise due to failure of the borrower. On- recovery of loans, either principal or interest forms a major hurdle in the process of credit cycle, and affect the banks performance. The financial system in the economy is like the circulatory system in the human body. And banks form its beating heart. If banks falter, the flow of money stops and the economy suffers the equivalent of a heart attack. In India banks are not doing terribly well. They have lent unwisely. As a result, many loans have “become overdue” and several borrowers are not in a position to pay back their debt. This has made many a loan a non-performing asset (NPA). When borrowers are in default or in arrears on scheduled payments of principal or interest for specified period, usually 90 days, the loan is Classified as NPA. All banks around the world have some NPAs but, if they become too large, banks can collapse. If the banks are big enough, this can cause the meltdown of the entire financial system. Non -performing assets (NPAs) have emerged as a alarming threat to the banking industry and it is sending distressing signals on the sustainability of the banks. According to CARE rating , India had the fifth highest NPA ratio in the world, ranking only after Greece, Italy, Portugal and Ireland. India’s NPA ratio stands at 9.85%, while major economies such as Britain, the US, Japan and Germany have ratios less than 2%. According to the latest Financial Stability Report of the Reserve Bank of India (RBI), the NPA ratio is set to deteriorate to 12.2% by March 2019, which would put India in fourth position, overtaking Ireland. As per the RBI, 11 Public Sector Banks are under the prompt corrective action category, which means that the poor quality of balance sheets have to be addressed immediately to avoid potential meltdown.

In the light of the risks that Indian banks face, Ministry of Finance set-up the Bankruptcy Law Reform Committee (BLRC) in 2014 under the chairmanship of Shri T. K. Vishwanathan. The prime objective of the BLRC was to come up with a new bankruptcy framework that would replace the existing framework. All businesses are started with inherent risk and that is the key reason for the pay-off / profit that they make. Some of them may inevitably fail due to the idea which may have been misconceived or the failure in the execution of an adept business plan. But in general, every business, in spite of being well conceived, has a degree of risk to fail. Insolvency is a situation when a firm is unable to meet its financial obligations which are due to its creditors and when it is declared so by the court of law, it is called bankruptcy. The existing framework with regards to bankruptcy and insolvency in India are as follows:

- (i) The Presidency Towns Insolvency Act, 1909.
- (ii) The Provincial Insolvency Act, 1920.
- (iii) Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act.
- (iv) Recovery of Debts due to Bank and Financial Institutions Act, 1993. Companies Act, 2013.

- (v) Sick Industrial Companies (Special Provisions Act, 1985).

We can see from the above list that there are multiple laws that deal with insolvency and bankruptcy in India which overlap and there are adjudicating forums for financial failure which has led to time consuming legal redressal process. To curtail the problem of overlapping jurisdiction, India has taken a giant leap in introducing the new Insolvency and Bankruptcy Code (IBC), 2016. The new code will streamline the resolution/bankruptcy process. It will provide exit options for insolvent and sick firms. It will ensure quick and prompt action in the early stage of debt default by a firm and hence will result in optimum recovery rate. There are two ways in which the banks' NPA positions might get affected by new IBC. They are as follows:

- (i) Filing under IBC for their existing corporate NPAs.
- (ii) The recovery value that the banks will get.

This code has been a revolutionary change, giving banks far-greater powers to recover their loans. They can now declare loans to be in default and initiate insolvency proceedings at the National Company Law Tribunal (NCLT). There are too few of these and not enough professionals to adjudicate these proceedings, but the lenders can finally claw back loans from defaulting borrowers and safeguard the hard-earned savings of hundreds of millions of Indians.

### **How will the New IBC affect the banks' NPA positions?**

There are two ways in which the banks' NPA positions might get affected by new IBC. They are as follows:

- (i) Filing under IBC for their existing corporate NPAs.
- (ii) The recovery value that the banks will get.

### **Options to banks for filing under IBC for their existing corporate NPAs**

There are three retorts in which the banks rely on for the recovery of their bad loans which are generally called as Corporate NPAs. They are:

- (i) To initiate the legal action against the debtor for the recovery of dues under Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act), 2002.
- (ii) The Sick Industrial Companies Act (SICA), 1985 or the winding up process under the Companies Act, 1956.
- (iii) The banks might opt for Corporate Debt Restructuring (CDR) or Strategic Debt Restructuring.

The IBC has given provision for converting the above cases to come under the purview of IBC. For the cases that are already pending under SICA at the Board for Industrial and Financial Reconstruction (BIFR) and Appellate Authority for Industrial and Financial Reconstruction (AAIFR), the 8th schedule of IBC provides abatement of the existing cases with an option to reinitiate them as new cases under IBC, within a time period of 180 days.

For cases on all other forums, be it legal or regulatory, they can be reinitiated as fresh cases under IBC. All the winding up cases can also be reinitiated under IBC except for one i.e. when the High Court has granted a stay on other legal proceedings being initiated while the winding up is being heard.

There are two possibilities here:

- (i) Status quo will prevail and the Creditors may not approach IBC. The banks, even though they could find an early NPA, may not report or may not bring it to IBC as they must make sufficient provisions and sometimes have to incur losses if the recovered value is less. Though there are losses if status quo is present, the banks might try to delay the bad news and hence may not initiate the IRP.
- (ii) Section 6 of IBC states that:

Where any corporate debtor commits a default, a financial creditor, an operational creditor or the corporate debtor itself may initiate corporate insolvency resolution process in respect of such corporate debtor in the manner as provided under Chapter II (Corporate Insolvency Resolution Process). Hence it can also happen that the parties other than the financial creditor may initiate the IRP and the other parties must follow suit.

Sections 7 to 9 of the IBC empowers the creditors, not restricted to financial creditor, to initiate the IRP and this is, way different, when compared with the earlier laws that had empowered only certain classes of creditors especially banks and financial institutions to trigger recovery or to initiate a resolution action.

Section 12 of IBC deals with the Time-limit for completion of insolvency resolution process. It states that: “The corporate insolvency resolution process shall be completed within a period of one hundred and eighty days from the date of admission of the application to initiate such process.”

“The resolution professional shall file an application to the Adjudicating Authority to extend the period of the corporate insolvency resolution process beyond one hundred and eighty days, if instructed to do so by a resolution passed at a meeting of the committee of creditors by a vote of seventy-five per cent of the voting shares.”

This is a welcome move as there is a perfect time limit given for handling the insolvency cases and the power to initiate is equally dispersed as well. Even if banks are not willing to initiate the process, if any of the creditor initiates IRP then the other creditors including the banks must fall in line and has to be part of the IRP.

### Analysis to study the impact of Bankruptcy Code on the banking system.

There are two ways in which IBC could affect the existing bad assets in the banking system.

- i) Reduction in NPAs
- ii) Recovery of the NPAs

The Gross Loans and Advances and the GNPA's of the Scheduled Commercial Banks in India for the past 8 quarters for the year 2015 and 2016 is as follows:

Quarter	31.3.2015	30.6.2015	30.9.2015	31.12.2015	31.3.2016	30.6.2016	31.9.2016	31.12.2016
Gross loans and advances	66,91,2014	66,08,114	66,31,162	69,87,362	72,73,202	71,87,268	72,70,276	72,69,643
GNPAs	3,09,399	3,28,666	3,43,454	4,36,883	5,66,247	6,15,429	6,65,864	6,97,025

We may analyze the impact in 2 ways:

- i. To study and analyze the quantum of impact of the IBC, we may regress GNPA numbers with key economic indicators like GDP growth rate, Consumer Price Index, Repo rate and Gross Loans and Advances Quarter-wise and may project the GNPA numbers for the next 8 quarters. The new addition to NPA or the fresh NPA scenario is where the maximum impact of the IBC can be seen. We may conduct a scenario analysis with three scenarios (Optimistic, Most Likely and Pessimistic) and may find the quantum of recovery that could be improved if banks utilize the IBC to the maximum extent.

The Asset Quality Review (AQR) carried out by Reserve Bank of India on the balance sheets of all the banks had a significant impact on the growth in Nonperforming assets in the system. It was a one-time exercise which made all the difference in the NPA figures that were reported by the bank.

Since AQR left a very big impact and there was a drastic increase in the GNPA's for all the quarters in 2015- 2016, we may not use the historical data for the regression as AQR was a one-time exercise and the real value of NPA in the system is the key to analyze the impact of

Indian Bankruptcy Code. The banks had understated the value of the bad assets as they have to make provision which might in turn affect their profitability. Hence, estimating GNPA's by using the historic value will not give us a right value.

### **Merits of the Indian Bankruptcy Code**

- i) The Secured creditors and the workmen wages for a period of 24 months has been given the higher priority even over the Government Claims which was not the case in Companies Act, 1956.
- ii) All the creditors now have concrete mechanism in place that overrides all the previous mechanisms which could be sought when needed. This will increase the Financial Discipline amongst the borrowers as they cannot escape the law and the resolution mechanism under the IBC is also time bound.
- iii) The non-financial creditors who did not have any mechanism in place, now has a set of well laid procedures which could help them recover their dues.
- iv) The Banks can no more hide the stress in the system as there can be instances where the non- financial creditors might have approached the forum way before the Banks classify a particular borrower as an NPA. This will improve the transparency in the system
- v) The normal time taking for a company to file bankruptcy and go for liquidation or take over is approx. 4.3 years in India according to World Bank's Ease of Doing Business rankings. The human capital and the enterprise knowledge would be lost and it will be really difficult to turn up the company and to put in the growth path. With the new Bankruptcy Code's definite time line of 180 days to maximum of 270 days, the human capital and the enterprise knowledge can be preserved.
- vi) The value of the firm deteriorates once it becomes non-performing and when it comes to liquidation after a period of 4.3 years, it will fetch only a stressed price which will be much less in value. With the new Bankruptcy Code and the stringent timelines for liquidation, the value the assets fetch will be much higher.

### **Demerits of the Indian Bankruptcy Code**

- i) The Institute of Company Secretaries of India, Institute of Chartered Accountants of India and the Institute of Cost Accountants of India have been registered as the Insolvency Professional Agencies and it is very clear that they have to undertake the tasks of Insolvency Resolution and Liquidation. It has to be found whether these

- bodies carry the operational expertise to run or turn around the company during the moratorium period. The independent Insolvency Professionals should be allowed so that there is a good competition and expertise across industries.
- ii) Development of Professionals with integrity and skills to perform the whole Insolvency Process adeptly is very crucial.
  - iii) Though the non-financial creditor may invoke the Bankruptcy Code, the committee of creditors only consists of the representatives from Banks and Financial Institutions. The Non- Financial Creditor does not have any voting right in the resolution mechanism. Conflict of interest might arise and it might not get the intended results
  - iv) The Interim Resolution Professional, who will run the company during the interim period before the Creditors committee arriving at a decision, may not have the expertise to run the company. Our experience so far with Asset Reconstruction Companies clearly shows that it is very difficult to turn around the company and if the companies end up in the wrong hands it will be even more disastrous. The Organizations that have been chosen only to bring the financial expertise to the table and they might lack operational expertise which would be the need of the hour.
  - v) A very clear demarcation is needed when it comes to tax recovery. If the Creditors approach the NCLT and invoke Bankruptcy and if the tax authorities take the full proceeds to recover their dues, the incentives for the creditors to take up this route might be very less.
  - vi) There is currently no cross-border insolvency framework.

## Conclusion

The New Bankruptcy Code is, indeed, a welcome step in terms of the bankruptcy process in India. We have addressed one of the key parameters in the Ease of Doing Business Index where we were lacking for years.

If implemented properly and if the Code evolves according to the changing economic climate, it will be highly beneficial for the lenders, borrowers, regulators and the Government at the end of the day. It improves the confidence in our system.

There is a long way for the players in the Indian system to behaviorally evolve and accept the concept of Bankruptcy, but when it is done, it will significantly improve the transparency in the system.

Once the system starts utilizing the IBC, after a year or so, we may study the actual number of the recovery rates of the banks and we may compare it with the period before which would tell us the exact significance and the impact of IBC.

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All the information made available in the report are taken from the public domain.

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