Creating a Robust Infrastructure for Credit

chapter 7

OVERVIEW

Debt claims are an important instrument of financing in an emerging market. Yet India's private credit to GDP ratio is low relative to comparable countries, its corporate bond market virtually non-existent, and retail credit growing rapidly but from a very low base. Part of the explanation for the low level of credit may lie in India's credit infrastructure, which is underdeveloped. Strong credit infrastructure is also useful when it comes to dealing with distress and reallocating resources to their best use. This will become increasingly important as India shifts out of mature low-skilled industries into high-skilled frontier technologies in the process of catching up. All this suggests a need for a very close look at the credit infrastructure to remedy what is deficient.

The flow of debt requires a number of facilitating mechanisms. Information about a borrower's credit history, if widely shared, and if it includes both positive information and negative information, could greatly help expand both access to credit and incentives to repay it.[1] For instance, a steady record of paying electricity bills or rent could alert potential lenders to a person's creditworthiness, and give them incentives to lend. The fear that a default would be publicized and would lead to a cut-off of further credit or of services can be the 'reputational' collateral that gives borrowers incentives to pay and lenders to moderate interest rates.

For credit information to be aggregated and shared, a primary requirement is a unique national identifier for each individual. Rules ensuring information accuracy, security, adequate privacy, and prevention of abuse are necessary, but they should take into account costs of implementation, as also the substantial benefits from information sharing. For instance, if most of the economy does not have access to credit from the formal financial sector, restricting the sharing of credit information to only financial institutions ensures that much of the economy, including the neediest sectors, do not benefit.

Most borrowing takes place against collateral/security. It is important to ensure that real assets can be pledged easily, information about pledged assets is easily accessible to potential lenders through collateral registries, and the security interest is easily enforced so it does provide security to the lender in case of default. Collateral registries that are universally accessible are another important aspect of credit infrastructure development.

Perhaps the biggest source of collateral value in India in the years to come will be land. This is also the form of collateral most easily available to rural India. Yet land mapping is uneven, land title is not final, land registries typically do not have complete records, records conflict with those maintained by the revenue department, and both are also typically hard to access. Expanding the use of land as collateral is one of the more important of the needed reforms, especially for the poor.

In order for debt financing to be available, creditor rights have to be protected. While it is easy to feel sympathy for the distressed debtor, too easy violation of creditor rights, or political agitation preventing creditors from enforcing interests, will make it harder for potential borrowers to get access to credit. At the same time, debt will occasionally be impossible to pay. Both the borrower (whether individual or firm), the society, and even lenders can be better off if the debtor can restructure unpayable debts using a low-cost, speedy framework that affords appropriate amounts of relief without vitiating the whole culture of repayment. The key word here is balance. Too harsh and rigid a system of debt enforcement will be both politically infeasible (in the sense that, even if enacted, politicians will intervene constantly and will have public support in doing so) and reduce borrowing as potential borrowers weigh the substantial costs of distress. Too lax a system of enforcement will weaken lenders and reduce lending.

Society therefore needs an effective system of debt enforcement and protection of creditor interests, a speedy and low-cost system of renegotiating debt outside the legal system, and a transparent, fair, and speedy bankruptcy process that can determine the best future use of the debtor's assets, while also determining and satisfying all legitimate claims on the debtor following a pre-agreed system of priority. Also, if some of the other improvements in credit infrastructure are implemented, such as the sharing of credit information, a better system of personal bankruptcy can be evolved.

It would take us too far afield if we were to detail all the infirmities in the current credit infrastructure. The most typical infirmities are the following: first, the system is fragmented in jurisdiction, operations, and coverage. An example of fragmented jurisdiction is that there are multiple avenues for bankruptcy resolution such as the Companies Act, the BIFR/SICA, and the Debt Recovery Tribunals. An example of fragmented operations is that collateral is registered both at state registries (e.g., immovable property) and the register of charges under the Company Act (for example, charges against equipment), and there is little communication between them, and between the various state registries. This multiplies the task for a potential lender who wants to verify encumbrances on a borrower's assets. One stark measure of the fragmentation in coverage is the fact that credit registries cover only 11 per cent of the population in India (data in the paragraphs that follow are from the World Bank's *Doing Business 2008* report), while they cover 40 per cent of the population in China and between 46 and 64 per cent of the population in Brazil.

Second, the system is slow and costly. For example, the time taken to register property among the BRICs is by far the highest in India at 62 days, and the costliest at 7.7 per cent of the property value. It is the lowest among BRICs for China, where it is 29 days and 3.6 per cent of property value. It is disquieting that transactions taxes and fees such as stamp duties and registration fees are very high in India and extremely variable across states. Such transaction taxes are a bad form of taxation because they inhibit transactions.

Third, because of the delays (sometimes endless), the system prevents the reallocation of assets to their best use, and greatly wastes asset values of impaired debtors, to the detriment of the economy. Closing a business also takes a long time in India—on average 10 years in India compared to 1.7 years in China. Among the BRICs, India recovers the least value at the end of the bankruptcy process—12 per cent of debts—while China recovers 36 per cent of debts.

These infirmities do impair the flow of credit. Credit to GDP averages 8 per cent for the 10 countries ranked at the bottom in the World Bank's 2008 Doing Business report on measures of credit registries and collateral laws, while it averages 130 per cent for the 10 countries ranked at the top. Indeed, as some of the comparisons above show, even though China is reputed to have an inferior financial system than India's, it scores much higher on measures of credit infrastructure, especially after recent reforms.

Finally, it is easy to be complacent in these times when reforms like the SRFAESI Act are 'working' in that debtors are paying up. While not downplaying the extent of reforms that have taken place, one should recognize that it is relatively easy to restructure and renegotiate debt during a boom, when debtors find it particularly attractive to repay and recapture the use of their assets, especially land. Matters may be quite different during an economic downturn. Now is the time to make serious reforms, for an adequate credit infrastructure will enhance the stability of the corporate sector, the household sector, as well as the banking system. While it would seem that all parties have to gain from such reforms, unfortunately, there seems to be little urgency at present. This must change.

CREATING A NATIONAL ID[2]

Every country needs some basic and robust identification mechanism for its citizens for various purposes. It will have two critical components—enumeration (assigning some unique number) and personalization (enabling positive identification of individual by his/her biometrics such as photo, etc.) For example, individual may have a number assigned but not a photo document (as is the case with the US Social Security Number); or, on the other hand, individual may have a photo document issued but no unique lifetime number associated with it (as would be the case with some national passport systems that would have a document number but not an individual number provided).

An identification system should ideally be unique, universal, and widely recognized. It should be provided through a mechanism that is universally supported by various agencies. A unique ID establishes a person's identity in a decisive manner and is a critical element of any functional credit infrastructure for financial inclusion. Countries lacking such system will be bound to have less efficient retail banking and credit systems.

ID schemes elsewhere

A number of identification mechanisms and national ID programmes exist across the world in various forms. The first ever smart card based ID scheme was launched by Malaysia, with multiple applications on the chip, and incorporating biometrics in the form of fingerprints of the holder. The Nigerian identity card is a plain plastic card issued to all above 18 years and provides identification based on profession and vital statistics like height, age along with personal information, photograph and fingerprints at the backend. The fingerprints are used for removing duplications in the system. The Nigerian card is required for commercial transactions, as an identity proof, for availing health care and other state provided benefits, educational admissions and for procuring other important documents like passport, driving license, etc.

In the Sultanate of Oman, the first to issue smart cards in the Middle East, the card comprises of high-end security features and applications like biometrics and digital signatures and capability to load new applications to the card post issuance. The card caters to multiple applications like driving license, passport and work permit. In Sri Lanka, the national ID is used widely by various public programs. The card itself is a simple laminated paper card; however, efforts are underway to modernize it by developing a database, introducing modifications into the number structure, and setting up a sound data collection process including the thumb imprint capture.

Perhaps the best in the region national identification system is hosted by the Government of Pakistan: it uses the medium of a smart card, storing photo and fingerprint information; it is broadly and universally used; it operates with a support of a very robust back-end electronic database and relies on the network of specially designated local offices.

ID programmes in India

India is still at an early stage of developing a universal national identification system. This allows the country to take advantage of the existing international experiences and state of the art technology. It is also important that various government bodies work together and fully coordinate their efforts to provide varied services to the same population. At present there seem to be few examples of such cooperation.

A number of current government programmes in India require the identification of a person or household. As a result, multiple identification mechanisms are in use, without any link between them, varying widely in terms of quality of the document issued or the process supporting it. The PAN card (Permanent Account Number) is used by the income tax department to identify income tax payers. The Elector's Photo Identity Card (EPIC) is used by the Election Commission and issued to people of 18 years and above. Yet another set of identity cards are used to provide various government cash transfers and benefits. The BPL card is an identification based on income criteria and used for the receipt of various benefits under government schemes. The Ration card used by the public distribution system is issued to a family unit as per the socio-economic criteria to enable low-income households purchase subsidized food and kerosene. Beneficiaries of the Rashtriya Swasthya Bima Yojana (RSBY, health insurance for BPL families) are issued smart cards, which not only offers a unique number, but also contains security keys, fingerprints and details of the family members, and a group photograph of all the enrolled members.

In the banking and financial sector, it has been difficult so far to use any of the above described government issued identity cards for the purpose of providing financial services. Recently there have been a number of pilots where private players have been assisting banks and microfinance institutions to issue smart card based identity cards to customers (see also Chapter 3). These initiatives have been used not only to open bank accounts and provide microcredit, but also to provide cash transfers via NREGS, pensions, etc. These cards are largely capable of relating a single identification number or account number to multiple relationships with the bank. Much of these efforts are sporadic and localized or specific to the bank and card service provider. In the absence of specific guidelines, the card service provider largely determines the mechanism for identification of customers and generation of a unique identification number.

Instituting a national ID number in India

In order to set the groundwork for a universal national identification system, the government needs to work out a strategy that would include: (*i*) a common set of criteria for identification of individuals; (*ii*) mechanisms for coordination among various government agencies at the central and state level to ensure universal enrollment and sound administration; (*iii*) nomination of a steering committee that would be in charge of design and implementation of the policy and an executive committee that would ensure uniformity and correctness of the system.

If a universal, centrally sponsored national ID system is a distant reality given the initial conditions, perhaps a workable second best solution could be identified. For example, an arrangement where multiple agencies are engaged in issuing identification documents to the groups they serve in a highly coordinated fashion could go far along in the process to provide an ID that is widely accepted and recognized.

To facilitate operation of such a decentralized system, some minimum elements would have to be defined. These include the following: (*i*) a common universal design of the numbering system that is used by all participating agencies and helps agencies recognize and process each others cards; (*ii*) a multi-purpose centralized database that ensures efficient monitoring of this decentralized ID system—updates on issued/cancelled IDs would be periodically uploaded into this system, and the system could help detect duplicates; (*iii*) minimum operational standards that all participating agencies would need to adhere to, to ensure a transparent and efficient system; agencies would also need to submit to periodic audits; (*iv*) a common card which could bear the logo of the issuing agency but would be identical in look and features and would have minimum information required for identification (name, address, date of birth, photo, fingerprint, etc.); and (*v*) if possible, this new system should integrate with other core systems of individual identification such as birth, death, and marriage registers.

Allowing different agencies to issue the ID in a coordinated fashion could deal with the problem that the burden of verification is different for some purposes than for others—for instance, verification for the purposes of establishing citizenship or voting can be different from the verification needed to issue a tax payer ID. Individuals would choose to get their ID from the organization that most addresses their specific needs, minimizing personal costs, and ensuring that coverage is enhanced.

Also, rather than establishing a new ID, it might be more useful to examine the existing schemes running in the country and adapt and scale up one of them to be more widely acceptable. Under any scenario, one of the agencies would need to take the lead in designing the card structure and the enumeration system and in coordinating the process by which all agencies would come together to collaborate on this effort. Box 1 provides a quick overview of the existing enumeration/identification mechanisms from the perspective of their potential for scaling up and/or adopting them as a core standard for a universal identification scheme.

Box 1: Features of Key Identification Systems Currently Available in India and Opportunities for Scaling Up

Identification system	Observations
PAN Card	Pros: Covers sizable group of middle/high income population; no limitations on other categories to join; centralized computerized system; efficient outsourcing of the enrollment process. Cons: Low incomes at present are not covered; perception of implicit tax liability; lack of biometric data on the card.
EPIC Card	Pros: Potentially close to universal coverage among the age eligible citizens. Cons: Weak institutional set up and poor card design.
EPFO ID	Pros: Covers sizable population of the formal workers; has an extensive network of offices for enrollment; introduced new and efficient numbering system. Cons: So far experiences seem to have been limited to needs of the pension programme; may not cater to the larger set of unorganized workers or non-workers.
CRA ID	Pros: Will gradually expand to cover all government workers and potentially members of other population groups participating in the new pension scheme; interlinked with the PAN numbering system. Cons: New untested system; phase-in will take a considerable time; highly centralized operation but no local infrastructure except possibly for some outsourced services.
MNIC Card	Pros: A step up from EPIC card in terms of numbering system design and media of information (smart card). Cons: Lack of institutional continuity; deteriorating quality of existing dataset.
RSBY Card	Pros: Will cover most of the low income population; potentially a robust centralized computerized system; smart card based identification with photo and fingerprint. Cons: Early stages of implementation, lack of experience; no dedicated offices for maintenance/enrollment; lack of identification of individual.
Income based IDs	Pros: Covers most low income population; has highly decentralized and represented service network. Cons: Lack of computerization and inconsistent records; weak institution and administration; lack of dedicated personnel at the local level; lack of systemic updates (critical revisions introduced on 5 year cycles); focus on family rather than individual.

Another possibility is a partnership in this area between the government and non-government organizations, e.g., to facilitate enrolment and verification. Though such models are commonly used in many areas of governance, a more robust structure would need to be formulated to ensure proper collaboration, monitoring, and accountability. If well defined guidelines and a strong accountability can be guaranteed, a public–private partnership could provide for a most efficient model, reaching out to certain population groups in a most efficient way, ensuring fast implementation and roll out of the new scheme as can be seen in the PAN issuance and is also envisaged in RSBY case.

Once established, the unique ID would be the basis for storing information in credit registries. Borrowing and savings behaviour could be tracked via this ID, with the shared information resulting in credit scores that could both reduce the cost of offering credit over time, as well as offer borrowers incentives to pay. The objective should be to achieve near universal information sharing (at least on negative information) by bringing banks, cooperatives, MFIs, and NBFCs into the sharing network.

GATHERING AND SHARING OF CREDIT INFORMATION

Credit information bureaus help bridge the information gulf between borrowers and lenders, by helping lenders identify good borrowers through their past credit history. The practical consequence of this is better risk management, which enables banks and other financial institutions to increase their volume of lending and extend credit to segments of the population that may have previously been excluded, such as small and medium sized firms (SMEs). Credit reporting helps lenders by reducing default rates and helps borrowers by allowing them to develop payment histories or 'reputation collateral' that they can use in securing more competitive loan rates. Once loans have been provided, sharing data on payment behaviour through credit bureaus can help to limit problems of willful default (where borrowers do not make a good faith effort to repay). This is because a borrower's cost of paying late or defaulting on a loan to one institution is greatly increased by the effect this has on his credit history and thus his future cost and access to credit across the financial system.

A study based on more than 100 developed and developing countries shows that the existence of credit registries is associated with a higher private credit to GDP ratio, after controlling for other country-level measures of development (Miller, 2003; Djankov, McLiesh and Shleifer, 2005). A study on credit reporting firms in over 40 countries shows greater information sharing increases lending as a per cent of GNP and lowers default rates (Japelli and Pagano, Forthcoming.)

The situation in India

The Credit Information Bureau (India) Limited (CIBIL) is the primary credit information bureau. It was incorporated in 2000. Banks, financial institutions, non-banking financial companies, housing finance companies and credit card companies use CIBIL's services. Data sharing has been based on the principle of reciprocity, which meant that only members who had submitted all their credit data could access credit information reports from CIBIL. However the Credit Information Companies (Regulation) Act 2005 (CICA 2005) has allowed for a set of 'Specified Users' like cellular companies, insurance company, credit rating agencies, etc. who can have access to reports. Currently 146 credit grantors, including 77 banks with over 90 per cent of total credit outstanding to individuals have accepted membership and have committed to give data.

CIBIL has two bureaus, one for consumer credit and the other for commercial credit. The objective of CIBIL's Consumer Credit Bureau is to minimize defaults and maximize credit penetration and portfolio quality, by providing comprehensive credit information pertaining to individual borrowers. It contains over 100 million records. CIBIL has more than 4 years of credit history on borrowers and has been able to introduce a number of value added products such as generic bureau scores for individuals.

The Commercial Credit Bureau aims to minimize instances of concurrent and serial defaults by providing credit information pertaining to non-individual borrowers such as public limited companies, private limited companies, partnership firms' proprietorships, etc. The bureau contains 1.5 m records.

Once it was established, CIBIL has grown rapidly in a short span of time. Strict and regular vigilance and monitoring of the borrowers is essential to ensure quality and reliability of the information, which, in turn, requires participation by a large part if not all credit-granting institutions in the country in the information sharing exercise. CIBIL has taken significant steps in this direction. Nevertheless, there are some concerns about credit information sharing in India. These have to do with what is collected and shared, data security and integrity, and the degree of competition in the industry.

What is collected and shared

CIBIL typically collects and shares credit information. While CIBIL does a good job in covering the most important institutional sources of credit by volume, there are a large number of small credit institutions such as cooperatives and microfinance institutions that make a large number of loans in small volumes. To play a more effective role in inclusion, CIBIL will eventually have to cover these institutions, and should be given permission to do so. It could even contemplate extending coverage to registered moneylenders who follow an accepted code of conduct, a necessary step when so much of credit to poorer sections still comes from moneylenders.

For corporate borrowers, information on credit rating, as well as assessment of accounting and auditing standards and corporate governance may be useful, though these items, being third party evaluations should be purely advisory inputs in decisions. Perhaps most important of all in sheer volume would be performance on inter-firm credits, of the kind collected and disseminated by Dun and Bradstreet in the United States, which CIBIL is in the process of collecting.

Creditworthiness can be gauged from more than just past credit-related behaviour. Many individuals make steady payments outside the formal credit sector that could be used to gauge creditworthiness. Expanding coverage for individuals from just loan payments to other common payments, including rent, utilities, and cell phone bills, would draw in a lot more information, and cover a lot of potential borrowers who are now outside the formal credit system, resulting in better credit assessments and inclusion.

One constraint on coverage and sharing information is the principle of reciprocity—only those institutions that provide information to CIBIL can access reports. CIC Act 2005 provides for specified users, notified by the RBI, who can get access. The list of specified users, as well as non-credit contributors needs to be expanded as India gains experience with credit information. For instance, in the United States, landlords can access credit information. We need to move to a system where any person having a written authorization of the borrower or entity on whom information is being sought, ought to be able to have access to the credit records in question, with only the truly necessary safeguards. Among potential users should include a prospective employer, landlord, or creditor, whether bank or non-bank.

A number of specified users have data, and could well share it under the principle of reciprocity. But for some, the gains from using data are low, while the value of their data is high. For other users (such as potential employers), there is little data they can contribute. As more such users come into the system, the notion of reciprocity (I get to use data if I share data) becomes more strained. India should move from a system of reciprocity to one of subscription, where a subscriber gets access to data subject to verification of 'need to know and authorization to use' of the subscriber by the credit bureau. At the same time, efforts should be made to persuade non-users to share data (including through an appropriate mix of mandated sharing and payments).

Finally, how long a history should be shared? International best practice is to establish time limits on the length of the credit history available to a potential lender. Economic research shows that recent credit payment record is of most relevance for predicting future default. Moreover, the fact that after a certain period of time information, especially regarding defaults, will not be distributed to lenders creates additional incentives for the borrower to improve credit repayment behavior and to 'clean up' the record. For example, records are available only for 5 years in Australia, Brazil, Germany, Ireland, Peru, and Spain, and for 7 years in the US, and Mexico. In the case of bankruptcy, records are kept for 10 years generally. It is essential, though, that all information in the file is kept for this set period. Deleting records, or parts of records, significantly lowers the predictive power of the data in the registry and weakens the incentive the bureau creates for repayment.

Data security and integrity

The key to making credit bureaus and registries effective, reliable and profitable lies in widespread data sharing. This can only happen when data providers and users are assured that their 'trade secrets' are safe and when regulations ensure that the individual borrower is not exploited or discriminated against using the information available from credit bureaus. The regulations necessary to ease the operation and success of credit bureaus, therefore, include those concerning bank secrecy; data protection laws; laws on consumer protection; fair credit granting and consumer credit regulations; and provisions regarding privacy and personal or corporate secret in existing laws.[3]

In most countries there is a tendency to rely on industry self-regulation for ensuring data safety. Credit bureaus as well as their members have strong incentives to establish proper mechanisms for data processing and data protection. In general, development of mechanisms for data processing is driven by competition within the industry and developments in technology, while data security standards are set high to avoid the significant costs a loss of data or an unauthorized access may cause. However, an independent audit of data security for credit information firms should be mandated in India by the RBI to ensure compliance with best practices.

Some other aspects of protecting consumer information deserve consideration. The key aspect in ensuring privacy and authorized access to the data is to define a set of legitimate purposes for access. This set of purposes usually include not only consideration for granting credit or a lease, but also monitoring of existing credit, collecting on a credit, etc. and even for employment purposes. In some countries, the law requires consent of an individual to authorize issuance of a credit report by a credit registry. While requests from regulated financial institutions may not require authorization, as the set of specified users is expanded it may be necessary to require authorization when the request is from an unregulated or non-financial entity.

Identity theft is becoming increasingly common in developed countries. Concomitant with expanding the set of users will be the need to verify that the authorization from the object of the credit report is valid. While there are no easy solutions, the sooner the system moves to unique national identification numbers accompanied by biometric validation, the more it will be able to contain the problem of identity theft.

The object of the credit report, whether an individual or a firm, is in the best position to know who has a valid reason for accessing their report. They know where they have requested credit or employment and whether other firms or individuals have a valid reason to request the information. Therefore, one of the best ways to limit unauthorized use of credit information is to develop systems, which record all queries for an individual's report. Consumers can review this information if they think their data has been used in an inappropriate manner. This simple reporting tool can greatly help to detect misuse of the data by lenders and others who may request this information, as well as by staff of the credit reporting firm.

Currently potential borrowers in India can find out why they have been refused credit only from the lender and not from the registry, which goes against international best practice that allows the subject to view his/her own impaired record free or at a low cost. Notice of refusal of credit also serves as a good educational tool informing consumer of the importance of building good credit history and improving payment discipline. One impediment currently in the way of direct access is that the credit information bureau may have no way of verifying that the individual who is trying to rectify his record is who he is. As national IDs and biometric identification becomes more widespread, the credit bureau and the individual should be encouraged to deal more directly.

Procedures should be in place to facilitate challenges to erroneous data. Consumers should be able to review their reports and identify reporting errors via the Internet and by phone. It is particularly important that consumers have access to reports when an adverse action has been taken. Clear procedures should be established in regulations specifying the steps in the dispute resolution process and the time that credit reporting firms have to verify and respond to complaints. These regulations should seek to facilitate consumer access without hampering the functioning of the system or allowing its abuse. The CICA 2005 provides a number of guidelines for dispute resolution, and these should be implemented.

Fostering competition in the industry

Competition in the area of credit information provision is the key for expanding coverage, and improving the use of credit information. However, a few roadblocks need to be removed to pave the way for easier entry of, and greater competition among, credit information companies in India. The Committee notes that liberalizing access to credit information through a change in the information collection and sharing model is an important condition for the success of competition. Licensing too many bureaus without expanding access will simply fragment the market for credit information and affect the growth of this industry.

Moreover, dispersed ownership may have been necessary when the owners were credit-granting institutions, so that a single owner could not monopolize information. As new players who are essentially in the information-sharing business enter, this is less of a concern. Furthermore, with CIBIL already in existence, it is unlikely that new entrants would monopolize information. It would be sensible to allow experienced

Quality of Credit Information in India

At the moment, there is no independent verification of the data submitted by the bank to the bureau. CIBIL does not carry out verification of information using third party sources including courts, government registration department, company registry etc. An important reason is that these sources have not centralized information, or made them accessible in electronic form at remote locations. This is likely to be remedied over time as more information is captured in electronic form. The data is as good as the integrity of a bank's data. Also the information submitted by lenders does not use similar criteria. For instance, some use RBI loan classification requirements (standard, substandard, etc.) and others use 'days past due'. In addition, the PAN number does not serve as a unique identification number as not all customers register for a PAN number. Also, the PAN number is only given to the tax payer. While banks try to use date of birth and other information as a way to identify a person, it is still a poor substitute for a unique identification number. This will become a serious issue as the consumer credit bureau expands. National identification numbers are needed for data validation and matching accurately, but also to contain identity theft. In the absence of its availability in India now, the CIB industry is severally handicapped. Thus there is paramount need to shift quickly to biometric identification and validation, and a rapid roll out of a national ID.

Information Collected by Credit Bureaus in the US

1. **Identification and employment information—**Name, birth date, ID number, employer, and spouse's name. The credit bureau may also provide information about employment history, home ownership, income, and previous address, if a creditor requests this type of information.
2. **Payment history—**Accounts with different creditors are listed, showing how much credit has been extended and whether it has been paid on time. Related events, such as referral of an overdue account to a collection agency, may also be noted.
3. **Inquiries—**CBs must maintain a record of all creditors who have asked for a person's credit history within the past year, and a record of those persons or businesses requesting credit history for employment purposes for the past two years.
4. **Public record information—**Events that are a matter of public record, such as bankruptcies, foreclosures, or tax liens, may appear in a report.

   - Bankruptcy information may be reported for 10 years.
   - Credit information reported in response to an application for a job with a salary of more than US$75,000 has no time limit.
   - Information about criminal convictions has no time limit.
   - Credit information reported because of an application for more than US$150,000 worth of credit or life insurance has no time limit.
   - Default information concerning US Government insured or guaranteed student loans can be reported for seven years after certain guarantor actions.
   - Information about a lawsuit or an unpaid judgment against a person can be reported for seven years or until the statute of limitations runs out, whichever is longer.

5. **Accurate Negative Information—**When negative information in the report is accurate, only the passage of time can assure its removal. Accurate negative information can generally stay in a report for 7 years. There are certain exceptions:

   - Information about criminal convictions may be reported without any time limitation.
   - Bankruptcy information may be reported for 10 years.
   - Credit information reported in response to an application for a job with a salary of more than US$75,000 has no time limit.
   - Credit information reported because of an application for more than US$150,000 worth of credit or life insurance has no time limit.

Information about a lawsuit or an unpaid judgment against a person can be reported for seven years or until the statute of limitations runs out, whichever is longer.

foreign players to take significant stakes in new entrants so that they can transfer technology. Of course, a liberalization of ownership norms should also be extended to CIBIL so that it too can attract experienced strategic partners if it so desires. Finally, the Committee emphasizes that the multiplier effect from the credit information industry can be substantial, especially for inclusion, and hence urgent steps are needed to expand it so that it can support growth.

COLLATERAL, SECURITY INTERESTS, AND REGISTRIES

Overview

Let us now turn to the process of obtaining security or collateral for debt. Security is essentially a claim on a borrower's asset if a debt is not repaid. Security interests typically have to be registered with a public registry so that everyone knows the asset is pledged.

The law should allow for the following features:

1. Security interests in all types of assets, movable and immovable, tangible and intangible, including inventory, receivables, and proceeds; future or after-acquired property, and on a global basis; and based on both possessory and non-possessory (where the creditor does not hold on to the asset) interests;
2. Security interests related to any or all of a debtor's obligations to a creditor, present or future, and between all types of persons;
3. Methods of notice that will sufficiently publicize the existence of security interests to creditors, purchasers, and the public generally at the lowest possible cost, as also permit swift, inexpensive, and reliable searches using multiple fields (owner of asset, type of asset, location, amount of encumbrance, etc.);
4. Clear rules of priority governing competing claims or interests in the same assets, with the highest priority typically given to security interests.

Land as collateral[4]

Land is probably the single most valuable physical asset in the country today. Unfortunately, the murky state of property rights to land make it less effective as collateral than it could be. The current state of land rights has many other adverse effects, including preventing agricultural land from migrating to its best use, slowing land acquisition for industrial and infrastructure projects, clogging courts with disputed cases, and elevating the level of political conflict. While making land rights clear and transparent is expensive, it is probably one of the most pressing needs of the country today.

Land can be used more effectively as a source of collateral, first, through clear property rights in the form of clean title to land, and, second, through improving the menu of land tenure options so that tenants with secure tenure can borrow against evidence of their tenure.

The process of establishing clear title to land is not easy. India has two principal systems of land records: a deeds registration system and a land revenue system of record of rights (RoR). Multiple agencies and multiple systems exist in most states. Typically, a Survey, Settlements and Land Records Department prepares and maintains survey and mapping records and property cards where they exist. The Revenue Department prepares and maintains the record of rights and a Department of Registration and Stamps maintains the deeds registry with records on land transactions. These systems are neither comprehensive nor consistent with one another. In the past, maintaining accurate land records has been the prime responsibility of fiscal authorities, given the importance of land records in facilitating revenue collection. As a result, the use of land records in confirming property rights has been neglected. This has to be remedied now.

The deeds registry simply gives public notice of a transaction. However, registration of a deed does not imply any inference about the legal validity of the transaction or that the parties were legally entitled to carry out that transaction. Indeed, the registration office in India will, in principle, register any transaction, and in practice officers invest more time in verifying the identity of parties to the transaction than the physical location and attributes of the land.[5] This means that someone who has registered a past purchase cannot use the deed as proof he owns the land—in fact, there is always the possibility that some prior seller did not have ownership, so all subsequent transfers are invalid. Clearly, the uncertainty this creates over ownership is substantial. By contrast, under registration of titles, the register itself serves as the primary evidence of ownership.

One possible long-term goal could be to establish a single computerized title registration system that includes conclusive information about rights over land and the spatial extent of these rights. This will ensure security of title to landowners and provide plot information to the government and private users. This system is often referred to as the Torrens system of registration and has been implemented in various parts of the world (in various forms), including Australia, New Zealand and parts of the US and Europe. In India, a title registration system broadly along the lines of Torrens is being piloted in a number of states. To establish such a system it is important to have clear titles, make registration compulsory, facilitate complete computerization of records, and ensure consistency between the various government databases. Given the current state of affairs of land records and land administration, meaningful implementation of title registration is clearly a long-term objective.

Regardless of whether single title registration is the ultimate goal—and much can be achieved without going all the way—it is of critical importance to improve the deeds system. A number of states—Karnataka, Maharashtra, Andhra Pradesh and Gujarat—have taken this approach. The next step would be to functionally integrate the different databases used in land administration, namely the deeds and RoR systems, to provide land owners with a certificate that contributes relevant and current information pertaining to a plot, for example ownership status, transaction history, current and past mortgages and liens, and a map that allows identification of neighbours and general boundaries. The decision on whether to make the transition towards a full title registration system will depend on a number of factors, including political will to make the necessary legal and institutional changes, consensus on the desirability of incurring the costs entailed, and agreement on the establishment of a guarantee fund which is required for a title registration system.

The immediate steps that need to be undertaken include:

- **Full computerization and integration of land records.** Efforts towards computerizing land records were initiated in 1988 through central assistance, but progress remains highly variable (see box below). Government measures to encourage computerization could include (*i*) clarifying the policy and establishing clear criteria and accountability mechanisms for allocation of central funds on this; (*ii*) identifying and publicizing best practices on technical and legal issues and promoting exchange and communication among technical staff across states; and (*iii*) prioritizing full functional integration between records and registry.
- **Full cadastral mapping of land.** An important problem is that existing cadastral survey records are largely limited only to agricultural land. The inhabited portions of villages, as well as towns and cities, have largely remained unsurveyed. Identification of urban property is, therefore, only by means of description of boundaries. This has to be remedied.

  Even for agricultural land, surveys are dated. Even though resurveys are under way, the process of cadastral survey in India has not yet taken full advantage of modern low cost technology available in surveying and mapping. Though the state government departments undertake most of the cadastral surveys in India, the private sector is now becoming involved in these surveys. A relatively low cost method to implement basic cadastral mapping is to combine satellite imagery with existing village maps and other readily available spatial products. A central body to establish a regulatory framework and enforce technical benchmarks and standards could speed up the roll-out of proven models for cadastral mapping and avoid costly trial and error on the more complex issues of generating spatial data.

- **Settlement of land disputes.** Land disputes need to be settled to establish validity of titles for land. These would require special land courts (or administrative tribunals) that will deal exclusively with land disputes. A possible policy initiative in this regard is to set up some fast track land courts for the settlement of land disputes in rural and urban areas. This was done in Mexico, where 42 land courts and one appeals court were created, which dealt with nearly half a million conflicts in five years. In addition, a special institution to provide legal assistance to small landholders and represent them in court dealings was set up; this helped the poor access this dispute resolution system.[6] An out of court settlement procedure with binding effect could be pursued in parallel.
- **Reduction of stamp duty.** India has among the highest rates of stamp duty in the world. With Stamp Duty on the conveyance of immovable property ranging from 15 per cent in Bihar to 6 per cent in Gujarat and 5 per cent in Maharashtra and Andhra Pradesh, and an additional registration fee ranging from 0.5 per cent in Andhra Pradesh to 2 per cent in Bihar, India is clearly an outlier among countries, where the Stamp Duty rates range from 1 per cent to 4 per cent. It is necessary to reduce the rate to promote land transactions in a transparent manner and ensure the sustainability of any improvements made in land administration. Some Indian states, namely Andhra Pradesh, Jharkhand, and Maharashtra have significantly reduced stamp duties. Reduction of stamp duty has been included as a condition for accessing funds from the Government of India under the Jawaharlal Nehru National Urban Renewal Mission. All States who have signed up to access funds from this mission have had to provide a roadmap for reducing stamp duties to no more than 5 per cent in a definite timeframe. This is a welcome step. Revenue neutrality could be maintained by combining a reduction of stamp duty with an increase in the land tax.
- **Compulsory registration of all transactions.** A large number of land transactions, especially in case of succession, do not need to be registered, partly because it is deemed unreasonable to charge stamp duty on these. Requiring that any change in the revenue records as a result of succession triggers a corresponding change in the land registry, without any payment in stamp duty, will go some way in ensuring registries are complete.
- **Remote and easy access to registration procedures and to land records.** The use of Internet kiosks to access land records has proved very useful in increasing transactions in states where it has been tried.
- **Standardization of forms and computerization of land office.** Petty corruption, loss of records, delay in transactions and threat of fire or flood to records are some common problems that can be dealt with easily through standardization and computerization.
- **Elimination of restrictions on land markets.** Widespread prohibition of land leasing is not consistent with efficient resource allocation. It raises the cost to rural–urban migration as villagers are unable to lease their land, and often have to leave a family member (typically the wife) behind to work the land. Lifting these restrictions can help the landless (or more efficient large land owners) get land from those who migrate, and allow those who currently lease land informally to formalize their transactions and thus obtain institutional credit and other benefits. To the extent that liberalization of land leasing enhances owners' security and may allow adoption of long-term contracts, it is also likely to increase investment incentives for all parties.

A prerequisite to formalizing tenancy agreements would be to put in place a system of guaranteed titles that capture details on proprietorship, property extents, rights and encumbrances. Compulsory registration of lease-holds and on the owner's title would then provide tenants protection. Registration fees should be minimal and procedures simple in order for both tenants and landlords to formalize their contracts. The formal tenancy agreement would provide tenants the legal collateral to access credit based on tenancy. Of course, for such a leasing market to take off, owners should be confident that long-term tenancy would not lead to their losing ownership. With a vibrant market for land, and clear title, there would be little political justification for such a step.

It is also important to drop restrictions on the sale or transfer of interests of agricultural land to non-agriculturists which has little economic justification. If farmers were allowed to freely transact their land, they could retain more of the windfall profits from such transactions, without resorting to less profitable subterfuge. While the Committee understands there are important historical rationales for such prohibitions, the whole issue needs to be reconsidered as urban and non-farm employment increases, cities and towns expand, and the need to sell land and exit agriculture increases.

In sum, three steps would help facilitate access to credit from financial institutions based on tenancy of property: (*i*) Eliminate prohibitions on tenancy; (*ii*) Create a climate of judicial balance between landlord and tenant rights; (*iii*) Institute formal contracts between landlords and tenants that are clear, easy, affordable, and reliable, that protect the tenant's tenancy while not impairing the landlord's right to reclaim or dispose off the property after the period of contract, and with appropriate notice.

Status of Computerization of Land Record in India

Computerization of land records was launched as a centrally sponsored scheme in 1988–89. Though progress under this scheme has not been consistent across states, many large states have digitized basic land records data and have started the process of recording sales (mutations) and distribution of record of rights (RoRs) using computers. As of 2007, states that had completed data entry of RoRs included Andhra Pradesh, Goa, Gujarat, Karnataka, Tamil Nadu, Chhattisgarh, Madhya Pradesh, Maharashtra, Rajasthan, Sikkim, Uttar Pradesh, Uttarakhand and West Bengal. The states of Karnataka, Tamil Nadu, Gujarat, Madhya Pradesh, Maharashtra, Uttar Pradesh, Uttarakhand and West Bengal have stopped manual issue of RoRs.

Since land is a state subject, every state has independently pursued initiatives towards computerization of land databases. For instance, the RoR has been computerized under the *Bhoomi* project in Karnataka, *Mahabhulekh* in Maharashtra, LRMIS in Andhra Pradesh, *Tamil Nilam* in Tamil Nadu, and SWAN in Gujarat. Similarly, computerization of the land registration (mutation) has been implemented through the KAVERI project in Karnataka, SARITA in Maharashtra, CARD in Andhra Pradesh, C-STAR in Tamil Nadu, and RajCREST in Rajasthan. Progress has remained skewed, as despite efforts since 1988, most states have not progressed much beyond just data entry or piloting on a limited scale. In this regard, it will be important to disseminate more widely the best practices of successful states and design incentives that encourage lagging states to overcome resistance and bridge the gap with the progressive states.

The integration of textual and spatial data, linkage of registration with mutation and a comprehensive and standard database of land records across the country will be essential for efficient administration and policy making. As of today, these are stand-alone in nature, as there is no comprehensive framework to collate and integrate the data into a seamless system of land information management that could run on a geographic information system (GIS) platform and provide land data.

In fiscal year 2007–08, the central government announced a major reform initiative under the National Land Resource Management Programme (NLRMP). This initiative includes computerization, updating and maintenance of land records and validation of titles, as well as plans to provide a comprehensive tool for development planning. Under this programme, the following three layers of data: (*i*) spatial data from satellite imagery/aerial photography; (*ii*) topographic maps and other data from Survey of India and Forest Survey of India; and (*iii*) land records data—both RoR and maps, will be integrated into a GIS platform. The primary focus of this effort is to provide citizens with RoRs with maps to scale and other land-based certificates such as income certificates (particularly in rural areas), domicile certificates, information for eligibility for development programmes, land passbooks, etc. This would also act as a comprehensive tool for land-based development planning.

Source: Ministry of Rural Development (http://rural.nic.in); World Bank report, *India Land Policies for Growth and Poverty Reducation, 2007*.

Creating and registering security interests: Operation

We have examined concerns with the single largest form of collateral, land. Let us turn now to the process of registering a security interest in this and other property.

1. **Benefits of registering security interest**
   In order for creditors to establish they have a secured claim to an asset, and in order that prospective lenders or purchasers be made aware of prior claims, a well organized system to register and publicize security interests is essential. Registration of security interest is beneficial to all parties concerned:

- Debtors, because it allows them to obtain access to credit at a lower cost and more expeditiously than in systems where information about the encumbrances on the assets of the debtor is not readily available;
- Creditors, because it allows them to extend credit with relative certainty as to their rights:
  - Registration enables prospective secured creditors to ascertain whether the relevant assets have already been collateralized in favour of a prior creditor. In the absence of registration, secured creditors must rely on debtor assurances or undertake extensive factual inquiries.

    - Registration is needed to deal adequately with the consequences of an unauthorized disposition of the encumbered assets by the debtor.
- Third parties, because it puts them on notice as to potential encumbrances on the assets of the debtor. Registration establishes a clear date stamp, which together with the principle of first-in-time priority, provides an objective mechanism for establishing priority (and avoids litigation associated with falsified dates on securities).

2. **Preconditions for realizing the benefits of registration as outlined above**
Security interests are usually recorded in documents. In case of non-possessory security interest (where the creditor does not hold on to the asset), documents are the only place where the creditors' rights and interest are recorded. This makes registration critically important. Moreover, widespread registration increases the use of registration as creditors attempt to protect their interests.

Given the importance of expanding coverage, it is disconcerting that, as with several transactions discussed in this report, exorbitant stamp duties under state laws deter borrowers and creditors alike from obtaining security, or registering it. Given the benefits discussed above, stamp duty (and registration fees) should be reduced to such a level that it does not deter transactions, with the state benefiting from the increased economic activity it engenders (as well as the moderate taxation of larger transaction volumes).[7] The stamp duty rates and registration fees should also be uniform across all the states in India.

The registration system should be set up to permit the indexing and retrieval of information using some reliable identifier of the grantor such as his name or tax payer ID. The need for unique national identifiers is again obvious. The registration system should permit the creditor/ or the borrower to register the security interest within a reasonable timeframe. Reasonable public access to the registry should be assured by setting fees for registration and search at a cost-recovery level and making available remote modes, and points, of access. The system should also provide for registration of notices of securitization (or transfer of receivables/credit facilities which are secured). The system should dispense with the requirement of registering the security interest when the asset falls under asset specific registration requirements (see table below) that are already prevalent in India. It should integrate all registry databases (many of the state databases are not computerized, let alone linked to a common searchable facility), and be user friendly so as to facilitate efficient registration and searching. This will require some central coordination.

There should be a movement towards a conclusive proof of the transactions as found in modern registries so that creditors and others can rely upon their title search with certainty. The law should provide for reasonable rules on the allocation of liability for loss or damage caused by an error in the administration or operation of the registration and search system.

3. **Current regime for creation and registration of security interest in India**
In India, there is a well established system for registration of security interests created by companies incorporated under the Companies Act, 1956, but there is no registration process mandated for certain types of security interests created by individuals, partnership firms, cooperative societies, trusts, etc. Additionally, for certain categories of movable assets, there are asset specific registration systems in operation, and registration is required in respect of charges created on such assets irrespective of who holds the asset. The following table offers a brief snapshot of the existing structure, which underscores the lack of a Single comprehensive framework for registration of security interest covering all types of borrowers and all types of assets.

Other assets including intangibles such as copyrights, trademarks, or units of mutual funds, or government securities lack formalized systems of recognition and registration of security interests. Security interests in these are usually obtained along with mortgage or hypothecation of other assets, or require outright transfer/ assignment by way of security.

4. **Way forward to achieve a comprehensive registration regime**
The Committee sees three main options to register security interests in a comprehensive way.
(a) Using the existing network of Registrar of Companies and the Ministry of Corporate Affair's MCA 21 e-governance initiative.

The benefits of starting with the infrastructure the Ministry of Corporate Affairs

Applicable law/Enactment	Applicability to persons (All or specific)	Types of security interest covered for the purpose of registration	Security interest excluded
The Companies Act, 1956	Companies (governed by the Companies Act, 1956)	A charge on: • Debentures; • Uncalled share capital of the company; • Immovable property; • Book debts; • Movable property; • Floating charge on any property; • Calls made but on paid; • Ships; • Goodwill; • Intellectual property right.	Pledge
The Registration Act, 1908	All persons	Deeds pertaining to: • immovable property viz. mortgage deeds; and • debenture trust deeds.	• Equitable mortgage[8] • All movable properties (registration optional)[9]
The Merchant Shipping Act, 1958	All persons	Mortgage over ships	—
Motor Vehicles Act, 1988	All persons	Hypothecation[10] of Motor Vehicles	—
The Patents Act, 1970	All persons	Mortgage of the Patents	—
The Depositories Act, 1996; (NSDL/CDSL Business rules and bye laws)	All persons	Pledge of securities	—

already has in place are clear, especially because MCA21, its e-governance initiative already stipulates electronic filing of documents and has remote access through the Internet in place.

It will be important, though, that the system of registration of charges should be opened to individuals, partnership firms, cooperative societies, trusts, etc., and should extend to all assets through an extension of the mandate in the Companies Act, 1956.

(b) Using the nascent credit information companies (or alternatively, the depository infrastructure—which serves the capital markets).

Credit Information Companies (CICs) formed under the Credit Information Companies (Regulation) Act, 2005, are licensed and regulated entities with the infrastructure capabilities of undertaking the registration of security interests. Another alternative are the electronic depositories—the National Securities Depository Ltd and Central Depository Services Ltd. The use of CICs or depositories will require legislative action (amending the CIC Act or amending the Depositories Act).

(c) Using the yet-to-be-notified SRFAESI Act provisions dealing with the registry of security interests.

The SRFAESI Act envisages an entity to register security interest. Clearly, implementing this will require starting a registration system afresh.

This Committee believes that there is some merit in creating competing registration systems, especially in the private sector, but we should also guard against fragmentation of the databases. The database maintained by each competing registry should be accessible to anyone accessing other registries (on payment of the requisite inter-registry fee), and the search process should make the boundaries between registries seamless to the searcher (much as is envisaged for credit information bureaus). With this proviso, the Committee would advocate exploring all three options with the focus on making registries compete on registration fees, search fees, and ease of access.

INSOLVENCY AND CREDITOR RIGHTS: PRINCIPLES AND TAKING STOCK

Principles

A well functioning system of credit should provide mechanisms for dealing with corporate distress. It should broadly have four key elements:

1. An effective legal framework for creditor rights. A well-functioning system of credit should be supported by mechanisms that provide efficient, transparent, fair and reliable methods for recovering debt, including the seizure and sale of immovable, movable and intangible assets. This is particularly true in India where the bulk of business financing is debt financing, especially at the SME level.
2. An effective legal framework for corporate insolvency. Where an enterprise is not viable, the main thrust of the law should be swift and efficient liquidation of the assets of the business to maximize recoveries for the benefit of creditors. Piece-meal liquidation often generates less value than the preservation and sale of the business itself to new owners, and whenever feasible, this will be the preferred form of liquidation. Sometimes, though, the economic value of the enterprise is fundamentally sound, even in its existing form, and preserving the enterprise as a going concern will generate the most value for all concerned. The enterprise then needs to go through a process of rehabilitation, where claims are renegotiated, new finance obtained for investment, and certain organizational, managerial, and ownership changes made to preserve the confidence of claimants. The process of rehabilitation should be quick, easy to access, and cheap when deemed necessary, protect all those involved, permit the negotiation of a commercial plan, enable a majority of creditors in favour of a plan or other course of action to bind all other creditors (subject to appropriate protections) and provide for supervision to ensure that the process is not subject to abuse.
3. An effective legal framework for informal workouts**.** The formal legal process necessitates additional costs and delays that, whenever possible, should be avoided. Out of court informal corporate workouts are therefore preferable wherever possible. Informal workouts are negotiated in the 'shadow of the law', with the legal insolvency framework providing both a threat point if informal bargaining breaks down, and a way of giving legal status to agreements that are reached informally. Accordingly, the enabling environment must include clear laws and procedures that require disclosure of, or access to, timely and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, rescheduling, restructurings and debt-equity conversions; and provide favourable or neutral tax treatment for restructurings; and
4. Effective institutional and regulatory capacity for implementing the law. Any legal framework is only as good as the integrity and capacity of both the institutions and the personnel needed to carry it out.

Let us now consider the existing system for dealing with corporate insolvency in India.

Bankruptcy/restructuring framework in India: An overview

Legal framework

A rough sketch of the legal framework for restructuring would look as below.

Revival and rehabilitation provisions under the Companies Act, 1956 and the Companies (Second Amendment) Act[11]

The legal, court-driven framework in India is characterized by three processes: (*i*) the Companies Act, 1956 ('Companies Act'); (*ii*) the Sick Industrial Companies (Special Provisions) Act, 1985 ('SICA'); and (*iii*) the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 ('DRT'). At the outset, it is instructive to note that the Companies (Second Amendment) Act, 2002 ('Second Amendment Act') created a new quasi judicial mechanism, namely, the National Company Law Tribunal ('NCLT') which would encompass the power and jurisdiction of the Company Law Board, the Board for Industrial and Financial Reconstruction, the Appellate Authority for Industrial and Financial Reconstruction and of the High Court relating to company law matters.

The NCLT has not, however, been put into operation as yet. As the SICA has not yet been repealed, sick Companies however continue to be governed by the Board for Industrial and Financial Reconstruction ('BIFR') and the Appellate Authority for Industrial and Financial Reconstruction ('AAIFR') which are defunct. The legal structure is therefore, to put it charitably, in a state of transition, and this state of affairs needs to be remedied quickly. Fortunately, the economy has been doing well, but this state of affairs will not last forever.

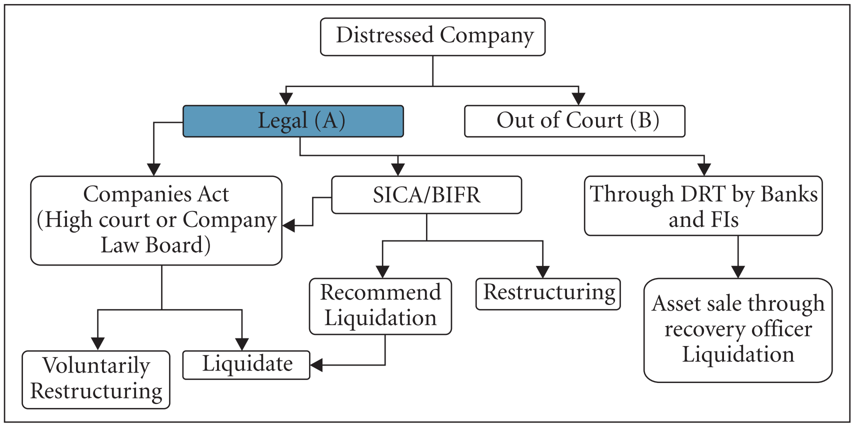
The Board of Directors of the industrial company classified as a 'sick industrial company'[12] under the Companies Act shall make a reference to NCLT within 60 days from the date of adoption of final accounts, and submit a scheme for its revival. On conducting an enquiry into the working of the sick company, NCLT may pass any of the following orders:

- That the company be given reasonable time to make its net worth higher than the accumulated loss or pay its debt;
- If the above is not possible, NCLT may direct an operating agency to submit a scheme of rehabilitation within 90 days, which may entail financial reconstruction; change in or take over of management; amalgamation with any other company; sale or lease of assets or rationalization of management and personnel. The scheme may also provide for financial assistance by way of loans, advances or guarantees or relief or concessions or sacrifices from the Central Government;
- If NCLT comes to the decision that the company cannot be revived, it may record its opinion to recommend winding up of the company and initiate winding up proceedings.

Winding up under the Companies Act, 1956 (the 'Companies Act'):

Under the Companies Act, 1956, there are two modes of winding up of a company:

- Winding up by the Court [13]
- Voluntary winding up which may be:
  - Members voluntary winding up
  - Creditors voluntary winding up
- Conduct of winding up proceedings.



Every winding up, whether it be by the Court or a voluntary winding up, is undertaken by appointment of a Liquidator, who takes under his charge all of the Company's assets and manages the affairs of the Company in a manner which would prove to be the most beneficial to the interests of the creditors, shareholders, and the Company itself.

Recovery under the recovery of debts due to banks and financial institutions act, 1993 (the 'DRT Act')

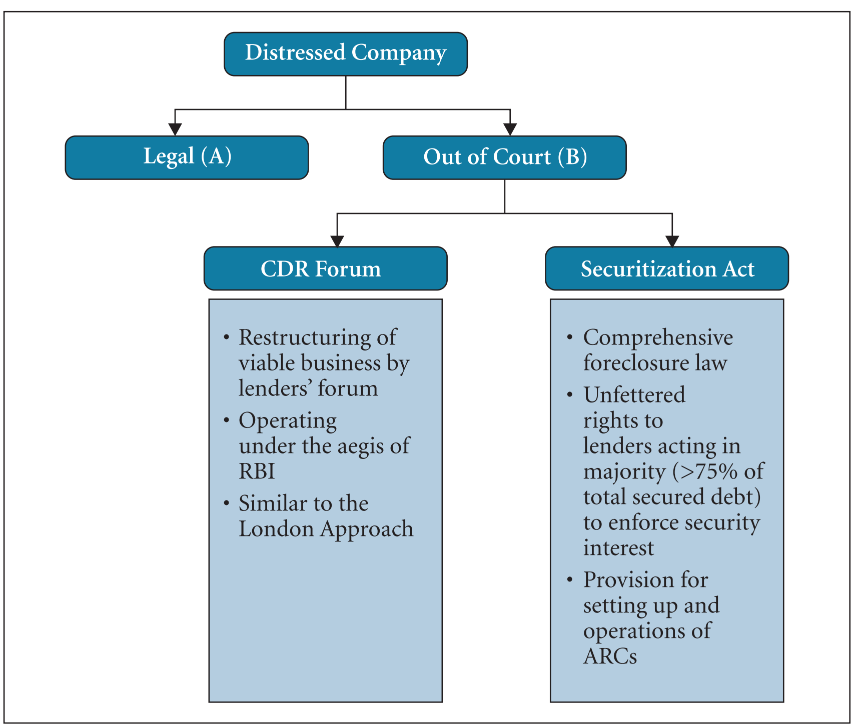
The DRT Act provides for the speedy adjudication of matters relating to recovery of debts that are due to notified banks and financial institutions. Every case pending before the Civil Courts, where the debt amount has exceeded Rs. 1 million, gets automatically transferred to the Debt Recovery Tribunal ('DRT' or 'Tribunal') established under the DRT Act. Once the Tribunal passes a final order, the recovery process is automatic and a separate application is not required to enforce the orders of the Tribunal. An appeal against an order of the Tribunal must be made to the Debt Recovery Appellate Tribunal within 30 days from date of receipt of the DRT order.

The DRT suffers from a number of weaknesses including the following:

- The DRTs were hampered for a long time, due to an insufficient number of tribunals and Presiding Officers—an urgent need to train Presiding Officers and cut down delays remains. Only 22 DRTs with 5 Appellate Tribunals located in five centres have been established so far.

- Though DRTs follow summary procedures for deciding cases, the recommended statutory timeframe of 6 months for deciding cases is rarely complied with. The proceedings before the DRTs often take more than 2 years and, fail to produce significant recoveries for unsecured creditors. If the matter goes into appeal to the DRAT, further time is taken and 3 years elapse before any recovery takes place.
- Recovery Officers by and large, lack sufficient judicial experience and are not adequately trained for their appointment. There is no transparency in the appointment of auctioneers by Recovery Officers.
- Different DRTs follow different procedures, leading to inconsistency and lack of clarity in approach of DRTs in matters involving the serving of summons on debtors, filing of original documents and evidence, permitting cross-examination of creditors, procedure on day-to-day conduct of proceedings etc.
- A Working Group to examine the functioning of DRTs was set up, but no further steps have been taken so far.

'Out of Court' Framework



Other creditors than banks and financial institutions must typically resort to the ordinary civil courts under the Code of Civil Procedure ('CPC') or pursue a foreclosure action under the Transfer of Property Act to recover debts. Both proceedings are cumbersome and time-consuming. The 2002 amendments to the CPC simplified procedures, but cases still take 5 to 7 years to get resolved. Decrees granted to unsecured creditors have little enforcement value.

Corporate Debt Restructuring (CDR) framework

The CDR Mechanism is a voluntary non-statutory system based on Debtor-Creditor Agreements (DCA) and Inter-Creditor Agreements (ICA) and all banks/financial institutions in the CDR System are required to enter into the legally binding ICA.

The CDR system in the country has a three-tier system:

- CDR Standing Forum and its Core Group
- CDR Empowered Group
- CDR Cell

The CDR Standing Forum is the representative general body of all financial institutions and banks participating in CDR system, which is required to meet at least once every six months and has the task of reviewing and monitoring the progress of the corporate debt restructuring system. Individual cases of corporate debt restructuring are decided by the CDR Empowered Group. The CDR Empowered Group is mandated to look into each case of debt restructuring, examine the viability and rehabilitation potential of the Company and approve the restructuring package within a specified timeframe of 90 days, or at best within 180 days of reference to the Empowered Group.

The CDR Cell scrutinizes the proposals received from borrowers/creditors and puts up the matter before the CDR Empowered Group within 30 days to decide whether rehabilitation is prima facie feasible. If found feasible, the CDR Cell then proceeds to prepare a detailed Rehabilitation Plan with the help of creditors and, if necessary, experts engaged from outside. If not found prima facie feasible, the creditors may start action for recovery of their dues.

Securitization and reconstruction of financial assets and enforcement of security interest act, 2002 ('SRFAESI Act')

SRFAESI Act addresses the interests of secured creditors'. Its purpose is to promote the setting up of asset reconstruction companies to take over the Non Performing Assets (NPAs) accumulated with the banks and public financial institutions. The Act provides special powers to lenders and asset reconstruction companies to enable them to take over the assets of borrowers without first resorting to courts.

In the event of default by a borrower, the Act empowers the lender to issue demand notice to the defaulting borrower and guarantor, calling upon them to discharge their dues in full within 60 days from the date of the notice. If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures: (*i*) Take possession of the security; (*ii*) Sale or lease or assign the right over the security; (*iii*) Manage the security; (*iv*) Ask any debtor of the borrower to pay any sum due to the borrower.

In case of financing by more than one secured lender the rights under the Act can be exercised only if supported by secured creditors representing not less than three-fourth in value of the amount outstanding. Such action is binding on all secured creditors.

The framework for bankruptcy resolution, as we have seen, is fragmented, complex, and fraught with delay. Some of the delays are because key resources such as trained judges are in short supply. Better legal management, more training, and more outsourcing of less central tasks could help reduce delays. But the framework itself needs consolidation and clarification. As more ventures are contemplated, such as infrastructure projects, that could result in complex bankruptcies and tie up enormous resources, the need to clarify the framework becomes even more imperative. The Second Amendment, when implemented, will improve bankruptcy resolution, while SRFAESI has improved creditor rights outside bankruptcy, but as discussed below, there is scope for improvement. We deal in sequence with reforms to the process of enforcement and out-of-court negotiation (section VI), and to the bankruptcy system itself (section VII).

DEBT RECOVERY AND REORGANIZATION OUTSIDE BANKRUPTCY

CDR

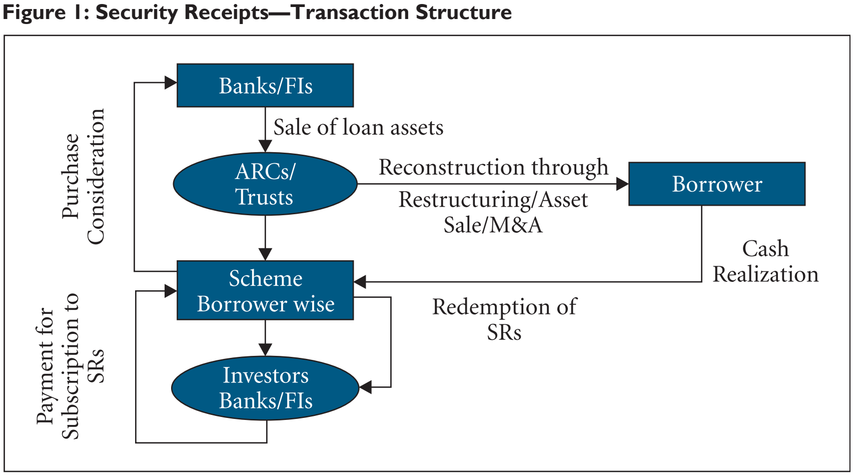
The RBI's Corporate Debt Restructuring (CDR) rules have facilitated many informal and out of court workouts of troubled companies. Nevertheless, there is significant room for improvement. An unintended consequence of the success of the CDR rules has been a proliferation of debt re-scheduling or, at best, 'balance-sheet restructuring' as opposed to more comprehensive operational restructuring. In the absence of an effective formal framework for reorganization (discussed below), this can have the effect of masking NPLs and creating latent, systemic problems. It is important to balance the CDR mechanism (which is largely creditor-driven) with a debtor-led formal process.

SRFAESI

Although potentially more efficient and time-sensitive than ordinary courts, the DRTs remain unable to complete the debt recovery process within a reasonable amount of time (the typical case takes approximately 3 years). SRFAESI presented a realistic and attractive alternative to DRTs and, indeed, after its implementation, the number of new DRT cases filed was reduced by almost 40 per cent.[14] Today, even after the SRFAESI amendments that placed certain limitations on creditor enforcement rights, SRFAESI remains generally popular amongst its core constituency, commercial banks. Nevertheless, there remain a number of key roadblocks within the system that should be addressed.

Although the experience with SRFAESI has not been uniformly positive,[15] there is a strong sentiment in the business community that 'it works'. By facilitating out of court enforcement, SRFAESI promotes the type of certainty that allows lenders to more accurately price risk and creates a legal environment conducive to lending. The tools available under SRFAESI should now be expanded to other lenders besides banks, public financial institutions, and housing finance companies. At a minimum, asset-based lenders (such as equipment financiers) should have access to SRFAESI-type provisions. Because SRFAESI encompasses non-corporate borrowers, expanding the definition of who can be a lender under SRFAESI would have the added effect of creating a single statutory regime for secured lending, applicable to virtually all business forms. This not only contributes to both transparency and simplicity, but also allows for greater competition amongst lenders as all lenders, will have access to the same legal provisions on enforcement. Of course, due regard will have to be had to potential abuses of the extraordinary enforcement powers in the act, but there is no evidence to suggest that these would be worsened by expanding SRFAESI's users.

Figure 1: Security Receipts—Transaction Structure



Asset reconstruction companies (ARCs) in India

Asset Reconstruction Companies world-wide can be classified into: (*i*) Government owned/supported ARC; (*ii*) Bank owned ARC—workout units and bad bank models; (*iii*) Private sector ARCs. India follows the 'Private sector ARC' structure, where ARCs may be set up by lenders, specialized investors in non-performing loans (NPLs) or corporations. There is a restriction that no shareholder in an ARC may have a controlling interest with the intent of preventing a lender from using an ARC as a 'warehouse' for its NPLs. Indian law allows the sellers of bad assets to double up as investors. So, when an ARC buys bad assets from banks, it issues Security Receipts (SRs) to such banks and instead of being a lender to bad assets, the banks become investors in such assets. Bad assets bought from different banks are pooled and SRs are issued against such a pool (see Figure 1). Banks are repaid as and when ARCs recover on the assets, and if the recovery is above the purchase price, the difference is shared by the investor and the ARC involved. This is, however, for such deals where SRs are issued. ARCs can buy bad loans paying cash also. In such cases, banks do not get a share of the extra money made through recovery.

ARCs bring some specific attributes to debt recovery. First, they can aggregate debt claims from a number of lenders, and from different classes of creditors, thus obtaining the legal and intrinsic leverage from being a large lender, as well as reducing conflicts between creditors. Second, they can acquire the specialized skill sets necessary for debt resolution. The SRFAESI Act has also provided wide-ranging powers to ARCs for resolution of NPLs. ARCs have access to all possible powers available to banks/FIs for resolution as also access to additional powers such as step-in rights and the ability to change management, and sell or lease the business [Section 9(a) & 9(b) of the Act].

The primary impediments to the more effective functioning of ARCs in India can be classified under three broad headings:

1. Limited supply of impaired assets coming on the market.
2. Limited set of buyers and capital entering the business.
3. High transactions costs.

Limited supply of impaired assets

The book value of the NPLs that banks/FIs hold on their books is higher than the 'market value' ARCs are willing to pay. The need to recognize an additional loss when assets are transferred comes in the way of transfer. This has real consequences since NPLs typically lose value over time as the impaired borrower's assets deteriorate. The solution is to require that NPLs be marked down on the books to market values that prevail in the ARC market. In turn this requires that prices ARCs pay be realistic assessments of value (and that banks have enough capital to absorb losses).

Such prices can be realistic only if the market is deep, with many sophisticated players on both sides. One step to expand the number of sellers is to amend SRFAESI to include a variety of other non-bank lenders under the definition of secured creditor under SRFAESI, and to allow these non-banks (such as NBFCs) to sell their assets to ARCs.

Limited set of buyers and limited access of ARCs to capital

On the other side of the transaction, the number of buyers can be expanded by licensing more ARCs. The institutional capacity to run ARCs can be found amongst foreign players. There is really no sensible case to keep foreign direct investment out of Asset Reconstruction Companies. The kind of risk capital as well as the kind of expertise foreign investors bring is useful in the economy, and can help provide a valuable buffer. From an economic perspective, capital that comes into the country when the banking sector is distressed, and a flood of assets are sold to ARCs is particularly valuable, and foreign investors, not domestic financial institutions, are most likely to be flush with capital at those times. The danger of ARCs buying from their parent financial institutions can be eliminated through specific regulations against self-dealing, and is anyway small for foreign institutions who do not have local operations. If there is a fear that ARC powers are too draconian to entrust certain players with (such as provisions of Section 9), it should be dealt with by amending the law rather than keeping out players with reasonable probity.

It should be noted that in a number of countries in Asia, there is active encouragement of foreign participation. In Taiwan there are no restrictions on foreign ownership of ARCs. Indeed, a tax incentive is provided to encourage foreign entry. That incentive is given by way of a reduction in the rate of withholding tax from 35 per cent to 20 per cent on dividends distributed to foreign shareholders in ARCs. Likewise, both the People's Republic of China and Korea have encouraged international participation in the market for NPLs promoted by the ARCs in those countries. In the case of Korea's ARC, KAMCO, it has used international bidding to dispose of NPLs. Some of those auctions have been conducted with put-back options enabling the successful bidder to resell NPLs to KAMCO as an additional incentive for investors to participate.

Finally, as with other forms of investment, it would help if mutual funds, insurance companies, and FIIs were allowed to invest in the senior claims and SRs issued by ARCs. Banks prefer cash for the assets they transfer to ARCs, and requiring them to hold SRs instead on their balance sheet is a poor use of bank capital. But ARCs will not have the cash to pay for the assets they buy unless they can access a wider pool of investors.

Transactions costs

As with every other financial transaction, the transfer of assets to ARCs is held back in some States on account of high incidence of stamp duty on such transactions. Several states have lowered or capped stamp duty on such transactions and this has helped facilitate transfers to ARCs. The SRFAESI has made an attempt to deal with this issue of high stamp duty in Section 5, which provides for the acquisition of financial assets by an ARC by way of an issue of debentures to the originators. However, this section does not contain clear provision for the vesting of the title to such assets in the acquiring ARC and further, it is not clear whether such an acquisition would attract the stamp duty payable in respect of an assignment/conveyance of financial assets. SRFAESI need to be amended to provide for a clear vesting of title in the ARC on an acquisition of financial assets by way of an issue of bonds or debentures under Section 5(1)(a).

DEBT RECOVERY AND REORGANIZATION IN BANKRUPTCY

Introduction to formal rehabilitation

By far, the most difficult and most pressing issue facing India's ICR system is the need for a functioning and realistic reorganization scheme, capable of being either debtor or creditor led. SICA and the related BIFR are considered failures. The Second Amendment proposed certain turnaround provisions for the Companies Act, but is generally viewed as not having gone far enough and, without the operation of the NCLT, has not had much effect in India.

There are myriad issues to consider when designing a rehabilitation scheme. Each issue raises a series of competing policy decisions that will be informed by, among other things, the experiences India has had with BIFR and SICA and their perceptions as failures, as well as the dramatic structural changes within India which demand flexible reorganization methods on par with those in more developed economies. The next section deals with the key elements that will need to make up an Indian reorganization mechanism. This list is by no means exhaustive, but identifies the critical elements that cannot be overlooked.

Key elements of an Indian formal rehabilitation scheme

Eligibility

The restructuring law needs to clearly define who it applies to. The challenge in India is to avoid both over- and under-inclusiveness. Certain types of entities in India, such as banks, insurance companies and major utilities, serve important economic and social functions. The ramifications of these entities becoming insolvent go far beyond the predominantly commercial considerations associated with ordinary businesses and, accordingly, it is perhaps best to exclude these entities from the restructuring law. At the other end of the spectrum, while it should be noted that the protections afforded and discipline imposed by a sound insolvency law should be as widely available as possible, in the Indian context it may be inappropriate to allow small businesses the right to a complex restructuring mechanism that could cause undue delay. This goes back to the important issue of ensuring a balance between liquidation and rehabilitation and, also, to the balance between using the law to facilitate debt collection (and access to credit) or to serve broader socio-economic purposes such as stability.

There is international precedent for a bi-furcated approach, which may be appropriate in the Indian context (subject to any specific constitutional concerns). Such systems are typically split along the lines of highly objective criteria (e.g., the total amount of debt owed to arms length creditors) that are not, themselves, likely to be contested. For entities that exceed the threshold, the full process should be available and, for those that do not, a more truncated process (without, for example, complex tools such as post-commencement financing and with shorter timelines) would be utilized.

Moreover, for all entities, there should be clear, bright-line rules for transferring a proceeding out of restructuring and into liquidation. This transfer could occur at a number of 'trigger' points, including determination by the court or insolvency office holder (in India, preferably the latter) that the restructuring process is unlikely to be successful or not in the best interests of the stakeholders. It could also occur immediately upon the failure of the restructuring plan and, in some cases, after a fixed length of time from the commencement of proceedings. This helps to balance the concepts of certainty and flexibility, and also addresses the often-expressed concern that the restructuring law should not undo SRFAESI's successes.

Commencement of proceedings

As noted in the Dr. J.J. Irani Committee Expert Committee on Company Law Report, the most appropriate commencement test in India is the 'liquidity' test. This requires that the debtor has generally ceased making payments and will not have sufficient cash flow to service its obligations as they fall due in the ordinary course of business. It is generally accepted that this test can be applied on a fairly objective basis and helps put a company under the insolvency law's protection before it is too late.

Moratorium and timeframes

One of the most contentious issues in designing the restructuring scheme will be the nature, applicability and duration of any moratorium on seizure of the debtor's assets. The moratorium is at the heart of the restructuring because it is the formal mechanism by which the debtor is given the breathing room to reorganize. At the same time, the SICA moratorium was widely abused and led to the need for, amongst other things, SRFAESI. Closely linked to this issue is the general question of time limits, which also poses some difficulty for India. Leaving the courts with unlimited discretion in determining timeframes opens the process to abuse, relies heavily on the judiciary's constant involvement in the case and creates too much uncertainty for creditors. Very tight timelines may, on the other hand, leave too little flexibility.

When a debtor has failed the liquidity test and approached the courts with an application for restructuring or rehabilitation, he should simultaneously be able to file for an automatic stay on creditors proceeding to seize assets. The automatic stay should begin upon filing and last until the first hearing by the courts. Given the delays that are otherwise likely in the Indian context, the first hearing of petition should be required by law to be heard within a short period (say 15 days) from the date of filing.

The automatic stay should stand vacated by law on the date of first hearing, whereupon, if the debtor wants to have the stay granted/continued for a further period (which again the law should prescribe), the court should consider this only after affording an opportunity to the creditors to be heard, and provided a majority of creditors by value support the continuation of the stay.

The law should specify clear and very narrow circumstances under which a judge can grant a further stay overriding the wishes of the majority of creditors in value. Among the necessary conditions for granting a further stay over the objection of a secured creditor (in respect of that creditor's assets) is if the court believes that the asset is vital for the restructuring and, importantly, that the secured creditor will not be materially prejudiced by the stay. A secured creditor or the insolvency representative should have a mechanism to seek extraction of a specific asset from the estate on explicit grounds during the life of the restructuring. Typically, these grounds relate to whether the asset is dramatically being reduced in value without some form of protection being provided to the secured creditor, or where the asset is deemed by the insolvency representative to not be necessary for the purposes of the reorganization. Whether the exceptions in this paragraph lead to substantial debtor abuse, or whether they offer some necessary respite from excessive creditor power is something only actual experience will tell. The legislation should be altered with experience.

Extension of the stay should be in fixed intervals (for example, 60 days) with a maximum number of stays (say 3) during the lifetime of the restructuring.

There should be reasonable timelines for the regular distribution of cash flow statements to the court and creditors, filing of the restructuring plan, voting on the plan and implementation of the plan. In the case of the latter three, the consequence of failing to meet the timelines should be a transfer of the case out of restructuring and into liquidation.

Control of the debtor

There is no universally agreed upon approach to the issue of control of the debtor company during reorganization. Many systems prefer the debtor-in-possession (DIP) approach, with existing management running the company, while others prefer the appointment of the insolvency administrator to control the company. There are some advantages to the DIP approach in that the existing management of the company are usually best equipped to continue the company's operation during restructuring in a cost effective manner (i.e., without the retention of outside professionals). On balance, however, DIP systems tend to be considerably more court-intensive in that, while the debtor remains in possession, creditors and the insolvency administrator often feel the need for the security of the court's direct involvement on specific issues.

By contrast, the 'administration approach' (where the insolvency administrator takes possession and control of the company, subject to court oversight) has seemed to result in somewhat less contentious proceedings and, in any event, less court involvement. While the court's involvement is not, in and of itself, negative, it has tended to make DIP systems considerably more expensive and, where DIP has been applied in countries where the courts have difficulty in quickly advancing cases, it has caused considerable delay. The Committee therefore recommends that whether the debtor be allowed to continue to manage be put to vote in the initial hearing, and it be allowed only with the approval of the majority of the creditors. Else the 'administration approach' should be followed and a cadre of well-trained professional bankruptcy administrators should be developed to implement it.

Post-commencement financing

In the vast majority of cases in which a company enters a restructuring, the company does not have sufficient liquidity to operate during the time it takes to restructure. The continued operation of the business during this period has been shown to be vital to the business' health. Employees and suppliers must continue to provide services and be compensated and the company must continue to trade so that its customer base is not eroded. Many countries, therefore, have adopted provisions by which a debtor in reorganization can obtain additional financing. In some countries, this is a purely academic question in the sense that no realistic market for financing troubled companies exists. In India, however, it is reasonable to hypothesize that a market for this type of financing could develop.

Post-commencement financing itself comes in many forms. At the most basic level, many companies need trade credit to order inventory. The most common approach to this issue, particularly when possession and control of the company is in the hands of an insolvency administrator, is to permit the administrator to take on such credit in its personal capacity, with such costs forming a priority charge over all of the assets of the estate. In practical terms, this is not usually a problem because, if the initial tests for restructuring have all been met, the continuity of trade is a foregone conclusion and the purchase of inventory will bring new assets into the estate for the benefit of the creditors.

More contentious is the ongoing payment of operating expenses when the company is operating on a negative cash flow basis. Although two broad approaches are prevalent here (one where the court can order a 'super-priority charge' ahead of all secured creditors on all assets for the purpose of obtaining additional capital and one where the debtor can only grant security over unencumbered assets unless secured creditor consent is obtained) in practice, there is little difference. Even in jurisdictions where courts are empowered to override secured creditor objections, they rarely do except in the most extreme of circumstances. Nevertheless, it would seem that, given the novelty of this concept globally, a more conservative approach is warranted. Such an approach would necessarily require the debtor to work towards a consensual solution with its largest secured creditor so that, in most cases, that creditor would be the one providing the additional financing in restructuring.

Approval of the reorganization plan

The desired result of any restructuring is the creation and approval of a plan that allows the debtor to emerge from restructuring in a viable state. Determining how this plan will be arrived at is therefore critical. In India, it is important that reorganization plans not be used as a tool to subvert the essence of commercial bargaining. In the long run, this will simply have a negative effect on the availability and cost of credit and, again, will cause the reorganization scheme to be viewed as just another tool by which debtors can avoid paying their obligations. As a result, there are some key principles to be observed: creditors should be grouped according to classes that are determined based on having a set of shared interests and rights; approval of the plan should be dependent upon a formula that requires both some form of majority approval within classes and of the classes as a whole; creditors of a similar class should receive the same treatment under the plan; creditors whose rights are being compromised in any way should have the ability to vote on the plan; if any class of creditors dissents but is being bound by the plan, the proponents of the plan should be required to demonstrate that such class is receiving no less than they would under liquidation.

Priority

The statutory priority of different claimholders to bankruptcy proceeds is typically a compromise between political and economic compulsions. While the need to protect employee claims such as overdue pay is important, there should be a limit (say six months) to which pay is protected, after which employees should also join the ranks of unsecured creditors. The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors. But perhaps most important, the statutory priorities of a firm should be well disclosed so that creditors can act well in time, before they get crowded out by other claims.

Personnel issues

Virtually all modern insolvency law frameworks rely upon a highly competent adjudicative body. Although truncating judicial processes may be an effective way of speeding up simple contract and secured credit enforcement, reorganizations will require an effective judicial or quasi-judicial authority. India possesses a large body of highly qualified, experienced judges and a relatively strong judicial branch of government. This is a strength that needs to be drawn upon in the design of an Indian restructuring system. In particular, the creation of a true specialized court, with appropriate training and resources (the NCLT), is a realistic option for India. Such a court would facilitate the implementation of more sophisticated restructuring tools that rely on an effective judiciary to constantly balance the interests of creditors and debtors.

In addition to facilitating the training of the judiciary in the finer points of finance, business, and bankruptcy practice—something that can be undertaken by joint programmes between some combination of the National Judicial Academy, business schools, law schools and expert judges/lawyers in India—there is also a need for a whole host of supporting staff such as the bankruptcy administrator or the official liquidator. It would be efficient to outsource these tasks to professionals such as business lawyers, consultants, or accountants on a case by case basis, making the chosen individuals 'officers of the court' in the same way that legal practitioners are (and holding them to the same ethical and professional standards). Alternative compensation structures such as a fixed percentage of the overall realizations, or a fixed percentage of the realizations for creditors, or a fixed amount plus a sliding scale of percentages, could be considered to give these professionals the right incentives. Reappointment to future cases should be on the basis of a sound track record.

More generally, specific guidelines will have to be created for the licensing, training, remuneration, supervision, and discipline/suspension of these individuals. Ideally, a self regulating body of bankruptcy professionals should undertake many of these tasks except for the last, which should be the charge of an external board set up by the NCLT.

Cross-border insolvency

Although briefly touched on in the Irani Report, cross-border insolvency is rapidly becoming a 'hot-button' issue in domestic insolvency reform in emerging market countries. As one of the largest recipients of foreign direct investment in the world, India has an urgent need for a mechanism of dealing with foreign judgements, cooperation and assistance amongst courts in different countries and the transnational nature of corporate entities.

India's ICR framework does not recognize the jurisdiction of foreign courts in respect of the branches of foreign banks operating in India. As such, if a foreign company is placed into liquidation outside India, its Indian business will be treated as a separate matter and will not automatically be bound by the same proceeding unless Indian stakeholders commence a separate proceeding. This results in confusion, multiplicity of proceedings and unnecessary costs.

The UNCITRAL Model Law on Cross-Border Insolvency provides a roadmap, adaptable to India's needs, for the treatment of foreign entities and foreign proceedings.

Review

No bankruptcy system, especially given India's complexities, will be born perfect. Whatever the bankruptcy legislation that emerges from parliament, a process of review should be undertaken every few years to examine its success in practice. Easy-to-collect metrics such as the duration of bankruptcy, the extent of creditor recovery, the number of successfully rehabilitated companies, the administrative costs of bankruptcy, etc. should be collected, and features of the bankruptcy code continuously examined to understand their practical impact. This will be especially important because new factors will emerge that will require change in the laws.

For instance, it is possible using credit default swaps (CDS) for a debt holder to completely hedge the risk of default of the debt he owns, and even stand to gain from default, despite owning debt. Such a debt holder has perverse incentives, and may frustrate the restructuring process based on a hidden interest derived out of his CDS position. This is an issue that is relatively minor in India today, but will undoubtedly become more important in the future. How bankruptcy code will have to be amended to take such issues into account is a task best undertaken by a future review.

PERSONAL BANKRUPTCY

The wave of farmer suicides has highlighted the importance of personal indebtedness. While suicides are a complex phenomenon, and cannot be attributed solely to indebtedness, it does raise the question of whether there are sufficient mechanisms to write down or even forgive the value of individual debts when they get too high.

Current provisions for personal bankruptcy essentially place severe penalties on an individual who is declared insolvent, with various statutes treating insolvency as a disqualification on par with insanity or moral turpitude. It may be worthwhile to debate whether a reform of personal insolvency provisions should be considered, that provides workout opportunities to individuals while protecting creditor interests. Because Indians have become more willing to take on debt, and not just in the agricultural sector, many more will experience difficulties. As the business cycle becomes a feature of the Indian landscape, many small businessmen without the protection of limited liability will be overwhelmed by their debts, and many middle class households will find themselves unable to their monthly installments.

We indeed need an urgent review of personal insolvency laws, as well as a framework within which debts can be renegotiated if excessively onerous, without making it too easy for debtors to escape obligations (which will hurt the debtors themselves as they will be unable to borrow). Such a framework should recognize that many debt claims may be from informal sources, that the most indebted may be very poor, that they may need counseling and financial advise as much as debt rescheduling, and that they may have little resources to navigate the legal system.

A first step towards credit counseling and mediation could be the Office of the Financial Ombudsman that is proposed in Chapter 6. That office can be a first stop in bringing creditors together and attempting a mediated settlement with the debtor. Such an out-of-court settlement may be the most efficient way to consensually renegotiate excessively onerous debts, with the shadow of the courts (such as the Lok Adalat) providing the backstop. At the same time, as the provisions for tracking credit histories become better, it may be possible to reduce the current penalties for bankruptcy substantially, imposing financial penalties (limited and costly future access to finance) on the bankrupt rather than moral or criminal penalties.

SECURITIZATION

Background

Securitization as a means of raising finance or transferring credit risk has existed in India since the early 1990s. Initially, it consisted primarily of quasi-securitizations[16] or Direct Assignments (DA). Portfolios or individual loans simply moved from the balance sheet of the originator to the investor (such as a bank), without any type of tradable security being created. Over time, the market has moved to more formal securitization involving special purpose vehicles (SPV). The individual loan(s) are assigned to an SPV (normally a trust) which issues tradable securities in the form of pass-through certificates (PTC) to investors.

The Indian market saw a significant increase in securitization activity in the period 2000–06, partly because of increases in retail consumer loans such as car loans, commercial vehicle loans, unsecured personal loans and residential mortgages. Despite the flexibility provided by direct assignment transactions, SPV transactions continue to grow since one of the most significant investors, mutual funds, can only invest in tradable assets.

Turning to assets being securitized, auto loans were the mainstay of the securitization market in the 1990s. Since 2000, residential mortgage backed securities (RMBS) have also contributed to market growth, though RMBS activity has slowed significantly during the last two years. Corporate loans, commercial mortgage receivables, project receivables, toll revenues, etc. have also been securitized. According to ICRA estimates, issuance volume in the Indian structured finance market grew at a CAGR of 34 per cent between FY 2003–07 and by 44 per cent in FY 2007. Asset-backed securities (ABS) claimed the biggest share in the market, accounting for 63 per cent in FY 2007, followed by CDO/LSO (32 per cent). RMBS, hindered by limited investor interest, amounted to less than 5 per cent of the total in FY 2007. The total size of the new issues was INR 370 billion.

Given that the underlying asset classes being securitized are largely retail and short or medium term corporate loans, the issuers are typically private sector banks, foreign banks, and non-bank finance companies (NBFC). The key motivations for originators are raising finance, generating a lower cost of funds (especially because securitization proceeds are not subject to capital requirements or reserve requirements), and management of asset liability mismatches. Key investors are mutual funds in SPV transactions and banks in DA transactions. The transactions are purely domestic with no cross-border securitization because there is little regulatory clarity on treatment of participation by foreign institutional investors (FIIs).

Need for securitization of trade credit

As yet, corporate accounts receivables (trade credit) are not securitized. The existing RBI guidelines do not make it clear whether revolving assets such as trade credit or working capital loans etc. can be securitized.

However, trade credit is a critically important source of finance for Indian firms across the board. For all firms together, the share of trade credit in total corporate financing has grown steadily from 7.25 per cent to almost 16 per cent during 2001–05. In 2005, it was the biggest funding source. Further, the proportion was much higher (26 per cent) for SME's.

SMEs could reduce their investment in working capital, and thus their need for finance, significantly if the receivables due to them from large firms could be securitized. In principle, such receivables, if accepted, are essentially commercial paper with the high credit ratings of the large firms. Further, if the SME can securitize and sell its receivable claim, its resulting smaller and better capitalized balance sheet would improve its credit worthiness.

Though the securitization process is similar to factoring, it could be more cost-effective than bank funding, factoring, and letters of credit. A negotiable Bill of Exchange (BoE) issued by a buyer against goods received provides a form of securitization of trade credit. The supplier can have the BoE discounted with any financial intermediary in a private transaction. The supplier and the intermediary can also endorse the bill in favour of any other party. Currently, mostly banks deal in BoEs, and usually the acceptance and discounting are kept under the credit limit set up for the buyer. However, the

Sources of Funds for Non-financial Indian Corporations

Year	All firms 2005	All firms Average 2001–05	SMEs 2005	SMEs Average 2001–05	Manufacturing 2005	Manufacturing Average 2001–05	Services 2005	Services Average 2001–05
	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Internal Sources	67	61	44	24	74	67	44	46
Equity	13	12	13	29	9	7	13	6
Debt	–3	0	1	0	–6	0	5	19
Banks & FIs	1	8	15	12	0	4	11	9
Group Cos/Promoters	1	2	4	2	1	2	2	0
Trade Credit	16	11	11	26	15	14	19	8
Others	5	7	12	8	6	7	10	12
Number of Observations	4,766	24,658	752	3,760	3,242	17,426	1,524	7,232

Source: CMIE, Prowess.

nature of the transactions and the physical format of BoEs rules out a sizable secondary market in them.

The Mexican development bank, NAFIN, created an electronic system where any small firm could present receivables on a number of large firms to it. NAFIN had set up arrangements with these large firms beforehand to have these receivables presented and accepted electronically. The accepted receivables, now full-fledged claims on the large firms, were then auctioned off in the market, and the proceeds paid out to the small firms. Nothing prevents a private sector entity in India from setting up this exchange, but the government could provide significant encouragement, as well as any needed legislative support. Therefore, the Committee proposes measures that will dematerialize trade credit receivables and enable them to trade in a similar way to commercial paper.

Specifically, we propose that:

- An organization like NSDL should provide dematerialization capability.
- An intermediary along the lines of NAFIN could tie up with large buyers and an authorized list of their suppliers to have automatic bill presentment and acceptance facilities. Such bills could then be auctioned, and the existing exchanges and reporting mechanisms (NSE/BSE/CCIL) should be used to trade and settle these instruments.
- Additionally, since most of these instruments are not rated, a formal rating programme along the lines of commercial paper could be instituted to enhance secondary market tradability.

Potential for freeing up balance sheets of small banks and cooperatives

Another important area where securitization can help is in refinancing small banks and cooperatives. This is an area where public entities like NABARD have typically played a large role in the past. If, however, the market for securitization became more effective, standardized loans made by small banks or cooperatives could be packaged and sold. Of course, a number of safeguards would have to be in place so that the kind of aberrations we now see in industrial country markets do not emerge. For instance, originating banks would have to retain a significant portion of the ‘first loss’ so that they have an incentive to originate higher quality credits, and so that they keep close tabs on the borrower.

With reasonable safeguards, the securitization market could be an important way of refinancing small and medium lenders such as cooperatives in rural and semi-urban areas, as is already the case in urban areas. One set of potential investors would be other banks. If the only buyers were banks through direct assignment, this would be equivalent to extending the Inter Bank Participatory Certificate (see Chapter 4) scheme to a wider category of institutions. The set of investors with a formal securitization process in place could, however, be even broader and eventually include mutual funds, insurance companies, and pension funds.

NOTES

1. Positive information typically refers to a past record of successful repayment of loans, rent, utilities bills, etc., but could also include information about the borrower's financial assets such as deposit accounts. Negative information typically refers to defaults on commitments.
2. This section was adapted from a note titled 'Inventory of the Personal Identification Mechanisms in India', prepared by Financial Information Network and Operations Ltd (FINO) for the Committee.
3. ISO 27001 is the most widely recognized information security standard in the world. This international standard has been prepared to provide a model for establishing, implementing, operating, monitoring, reviewing, maintaining and improving an Information Security Management System. CIBIL is ISO 27001 certified.
4. This section has benefited substantially from the World Bank report, *India Land Policies for Growth and Poverty Reduction*, 2007, and the interested reader is referred to that report for details.
5. *India Land Policies for Growth and Poverty Reduction*, 2007, p. 31.
6. This was also tried in Andhra Pradesh with some success.
7. The reduction of the stamp duty can be to nominal amounts, say of Rs. 100, or if calculated on an ad valorem basis, then at 0.01 per cent subject to a statutorily prescribed cap, say of Rs. 100,000. The registration fee itself can be a fixed nominal amount.
8. Equitable mortgage or mortgage by deposit of title deeds is most prevalent in home mortgages—the reforms to the stamp duty and registration law could facilitate a move to mortgage deeds being obtained and diminish the utility of equitable mortgages.
9. Optional registration also lacks the pre-requisite of mandatory registration—it does not amount to public notice, which other registrations, as listed, ensure.
10. The Act also deals with finance in nature of lease and hire-purchase, and consequent recognition of separation of ownership (with the financier) and user (the person availing of finance).
11. The Companies (Second Amendment) Act, 2002 incorporates the regime governing sick industrial companies from SICA, 1985 into the Companies Act, 1956, in the form of part IV A – the provisions of which are yet to be notified.
12. 'Sick Industrial Company' means an industrial company which has the accumulated losses in any financial year equal to 50 per cent or more of its average net worth during four years immediately preceding such financial year; or failed to repay its debts within any three consecutive quarters on demand made in writing for its repayment by a creditor or creditors of such company [Section 2 (46AA)].
13. Substituted by 'National Company Law Tribunal' by the Companies (Second Amendment) Act, 2002, w.e.f. a date yet to be notified.
14. Reserve Bank of India Report on Trend and Progress of Banking in India, 2004–05.
15. Amongst other complaints, borrowers suggest that SRFAESI's tools remain too draconian, even after reform, and lenders assert that the limited appeal rights available under SRFAESI are still open to abuse.
16. High Level Committee on Corporate Bonds (2005) has used this term.