

The way forward for personal insolvency in the Indian Insolvency and Bankruptcy Code

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Abstract

In 2016, the Indian Parliament passed the Insolvency and Bankruptcy Code (IBC). The Government has chosen to notify only the part on corporate insolvency. It is expected that the part on personal insolvency will be notified for individuals with business debt and personal guarantors. In this context, this paper describes the Indian credit market and presents an argument for the need for personal insolvency law. It provides a brief overview of the provisions on personal insolvency in the IBC. It makes suggestions on questions of policy that need to be addressed before the law can be meaningfully implemented as the success of the IBC depends on the design of the subordinate legislation as well as the evolution of the institutional infrastructure.

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1 Introduction

In 2016, the Indian Parliament passed the Insolvency and Bankruptcy Code (IBC), which contains provisions for both corporate and personal insolvency. While corporate insolvency has been restricted to limited liability firms, the scope of personal insolvency is much wider, and covers all individuals and partnerships as well as all creditors - financial and operational, secured and unsecured, formal and informal into its fold. The Government has chosen to notify only the part on corporate insolvency. In December 2017, the insolvency regulator, the Insolvency and Bankruptcy Board of India (IBBI), published draft regulations and indicated that these would be notified for a certain class of debtors, namely individuals with business debt and personal guarantors. The draft regulations will presumably be in force after the relevant sections of the Act get notified.

This paper makes three contributions to the discussions on personal insolvency. First, it describes the Indian credit market and presents an argument for the need for personal insolvency law. The debt to GDP ratio in India is much smaller than other emerging or developed economies. Even though NPAs on personal loans from the banking sector look small relative to those on loans to industry, they have been rising, and may continue to get bigger as individual lending expands. Personal guarantors of companies that are under corporate insolvency now find themselves under creditor action without a recourse to an insolvency law. Reports of agrarian distress indicate a serious concern regarding agricultural lending. Medium, small and micro enterprises (MSMEs) remain an important part of the economy, many of whom are organised as sole proprietorship's, and may be in financial distress. The stress stemming from informal loans remains unknown. Only institutional credit has recourse to two legal processes, the Negotiable Instruments Act (NI), 1881 and The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Act (SARFAESI), 2002, for recovery, thus leaving other types of lenders without any legal channel of recovery. Poor frameworks for recovery have had an adverse impact on the credit market. These conditions emphasise the need for a personal insolvency law.

Second, it provides a brief overview of the provisions in the law. One of the biggest motivations of the Bankruptcy Law Reforms Committee (BLRC) in drafting the law was the potential impact it could have on the credit market in India, and the structure of the law is driven by this objective. The IBC provides three distinct processes for dealing with default. The "Fresh Start" process provides for a debt-waiver to debtors who meet very specific eligibility conditions in terms of their income, assets and debts, and thus is likely to apply to a small set of people. The "Insolvency Resolution Process" provides a mechanism for creditors and debtors to renegotiate a repayment plan, while "Bankruptcy" provides for

liquidation of debtors assets, but can be used only if the resolution process fails. The law designates “Debt Recovery Tribunals” (DRTs) as the adjudicating authority of the code owing to their wider presence relative to the National Company Law Tribunals which is the adjudicating authority for corporate insolvency.

Third, the paper makes suggestions on questions of policy that need to be addressed before the law can be meaningfully implemented. It makes the case that the success of the IBC depends on the design of the subordinate legislation as well as the evolution of the institutional infrastructure. Both creditors and debtors need to perceive the processes as fair, the costs as reasonable and outcomes relatively predictable. For example, in the present scenario, it is unclear whether existing creditors will resort to immediately using the Code even if it is notified. Their interest will be based on how effectively the Code is able to reduce their costs - in terms of time and money - of recovery, and increase predictability about the process.

Debtors, at least in theory, might find in the IBC a tool to obtain a complete waiver of their debts (through the Fresh Start), or to stall creditor enforcement, and bring the creditor to the negotiating table. However, debtors are a dispersed group, may have social concerns about the stigma of bankruptcy, and may generally find themselves incapable of utilising a law that they are not financially and legally literate to understand. Also, if the law is seen as creditor-friendly, or institutional processes seen as costly and cumbersome, then it will fail at providing adequate insurance to debtors, incentivising them to actually avoid the IBC at all costs.

Since the law has not been notified, this is an opportune moment to revisit questions of design on personal insolvency law, and also shape the institutional infrastructure so that it can meet the demands that will get placed on the Code. High quality regulations, improvements in the functioning of the institutional infrastructure, setting up of advisory services for bankruptcy are critical for personal insolvency to have its effect.

This article begins with an overview of credit markets in India in section 2, and the need for a personal insolvency law in section 3. In Section 4 it describes the current framework in the IBC. Section 5 describes policy questions that need action for the successful implementation of the law. The conclusion is presented in Section 6.

2 The Indian credit market

The Indian credit market is divided into three kinds of lenders. The first are banks that include scheduled commercial banks, co-operative banks and regional rural banks regulated by the Reserve Bank of India (RBI), that are the dominant player

Table 1 Percentage of households with outstanding credit (Jan - April 2018)

Source	% of HH
Any source	31.5
Any formal	13.8
Banks	8.9
SHG	3.8
NBFC	0.9
MFI	0.5
Credit cards	0.2
Any informal	20.9
Shops	8.8
Friends and family	7.9
Money lender	3.7
Chit funds	0.3
Employer	0.1
Others	1.9
Both formal and informal	3.2

Source: Consumer Pyramids

in “institutional credit”.

The second are the non banking finance companies (NBFCs), also regulated by the RBI, and include companies in the business of housing finance, vehicle finance as well as micro-finance. The NBFCs typically do not take deposits. In recent times, P2P lending, PPI cards, fintech companies have entered this space, many of them as NBFCs. These firms are able to leverage on non-credit data of potential customers (such as spending patterns on online websites, or bill payments on phones) to evaluate credit-worthiness. They have been able to drive down their on-boarding costs through the e-KYC offered by the use of Aadhaar.¹

The third are informal entities and can range from money lenders and chit funds to friends and family. Some of these, such as chit funds and money-lenders are governed by Acts that vary across the different states in India. Little is, however, known about the efficacy of the implementation of these Acts, and it is widely believed that several of these institutions continue to be informal and unregulated.

Table 1 presents the percentage of households in the months of Jan - April 2018 who claim to have outstanding credit from various sources. The data comes from Consumer Pyramids, a pan-India household survey carried out by the Centre for Indian Economy. Consistent with the low credit-GDP ratio of India, only 31% of households claimed to have credit outstanding from any source. Overall, the presence of informal sources was higher (21% of households) than formal sources of credit (13.8% of households). However, individually it is banks that seem to be the most utilised source of credit (8.9% of households), followed by shops (8.8% of households) and friends and family (7.9% of households). Contrary to the popular

¹This may, however, change with the recent Supreme Court judgment that has held the use of Aadhaar based authentication by the private sector to be unconstitutional.

Table 2 Outstanding non-food credit of banks

	Rs.billion		% share in total	
	2008	2018	2008	2018
Total	22,048	76,884	100	100
Agriculture	2,753	10,302	12.49	13.4
Industry	8,583	26,992	38.93	35.11
Micro/small industry	1,326	3,729	6.02	4.85
Services	5,493	20,504	24.91	26.67
Trade	1,238	4,669	5.62	6.07
NBFCs	789	4,693	3.58	6.46
Personal loans	5,217	19,084	23.67	24.82
Consumer durables	97	197	0.44	0.26
Housing	2,603	9,745	11.81	12.68
Education	205	697	0.93	0.91
Vehicle	586	1,897	2.66	2.47
Credit card	267	686	1.21	0.89
Other	966	5,080	4.39	6.61

Source: CMIE Economic Outlook

narrative of the role of money lenders and micro-finance, only about 3-4% of households had credit outstanding from self-help groups and money lenders. Only 3% of households had outstanding loans from both formal and informal sector. There are three characteristics that are worth noting.

1. *Emphasis on secured credit*: The credit market in India largely delivers capital to those who have assets to pledge. This constrains entrepreneurship,² especially in service, technology and knowledge industries which require a system that lends based on an assessment of future cash-flows, and not on the basis of existing collateral.³ This can be seen from Table 2 which shows the credit outstanding by commercial banks over the decade between 2008 and 2018. The bulk of personal loans outstanding are housing, vehicle, consumer durable and education loans - all of which are collateralised.

While secured credit continues to dominate, the share of unsecured loans has been rising in incremental credit off-take since the demonetisation event of November 2016.⁴ The use of digital technology that is able to lower costs of delivering credit, and of evaluating credit worthiness of customers is also bringing in a change in access to credit.⁵

2. *Directed lending*: Credit disbursement in India is shaped by the “Priority Sector Lending” policy that mandates that all domestic scheduled commercial banks (and foreign banks with 20 or more branches) should disburse 40% of net bank credit to what are termed as “priority sectors”.⁶ These include

²As described by Banerjee and Duflo 2014 the lack of availability of adequate and timely credit is one of the biggest problem affecting the growth of the small scale enterprises in India.

³Sane 2015

⁴See Iyer 2018

⁵Khosla 2018

⁶The genesis of PSL was a study group in 1969 that observed that while agriculture contributed 50% to the national output, it received only a third of institutional credit. This led to setting of group-wise quantity targets for disbursement of credit. Over time other groups such as village and cottage industries,

Table 3 Outstanding credit of banks for priority sector

	Rs.billion		% share in total	
	2008	2018	2008	2018
Total	7,480	25,531	100	100
Agriculture	2,753	10,215	36.81	40.01
Micro industries	2,520	9,963	33.70	39.02
Micro-credit	133	263	1.78	1.03
Weaker sections	1,069	5,690	14.29	22.29

Source: CMIE Economic Outlook

agriculture, micro enterprises, weaker sections of society (which includes small and marginal farmers, artisans, self-help groups among others).⁷

Table 3 shows the total priority sector lending and its components. The share of agriculture has risen from 37% to 40% as has the share of loans to weaker sections from 14% to 22% in the last decade. Most of these loans would be loans to individuals.

3. *Political influence on lending:* A less discussed aspect of Indian credit markets is the linkage between politics and credit. It is argued that large amount of credit is driven through political patronage. For example, Cole 2009 finds that agricultural credit lent by public banks is substantially higher in election years. More loans are made in districts in which the ruling state party had a narrow margin of victory (or a narrow loss), than in less competitive districts. These loans are not linked to productivity or output improvements in agriculture. To the extent that lending is a “political” activity, decisions are unlikely to be made on sound credit risk considerations, with implications for default as well as recovery.

3 The need for personal insolvency

The functioning of credit markets depends on two factors. The first is the ability to solve “information asymmetry”. Lenders always know less than the borrower about her true ability and motivation, and have limited ability to monitor her actions. This makes them reluctant to extend credit. The second is the ability to make recoveries should the borrower not be able to repay her debts. If recoveries are difficult, then this too can hamper the growth in credit.

India has made some progress on solving the problem of information asymmetry through the use of credit bureaus, and increasingly through the use of data from mobile phone (and other) payment records, to social media networks. The

weaker sections, micro-finance were added to the definition of groups eligible for priority sector lending. The drive for continuing with the quantity targets comes from the need to somehow restrict the reach of informal lenders (such as money-lenders) who are seen as exploitative.

⁷RBI 2018

mechanisms for recovery, however, are few. This becomes especially relevant as the market grows both in size and complexity.

3.1 The individual credit market is growing

From banking sector data, it is difficult to establish the amount of credit that is disbursed to “individuals” as opposed to limited liability companies. It is likely that agricultural loans are mostly given to individuals, as are the ones to “micro and small industry” and “personal loans”. In addition it is likely that some of the loans given for “services”, “trade” and “NBFCs” are also passed on to individuals. This suggests that about 43% of bank loans are given to households.

Another way of judging credit disbursements is to evaluate the size of loans. In loan sizes upto Rs.10 million, agricultural and personal loans dominate, suggesting that these may most likely be taken by individuals. In 2017, Rs.13,903 billion (about 16% of all non-food credit disbursed) was disbursed in loan sizes below Rs.500,000. About Rs.15,089 billion (about 19% of all non-food credit) was between Rs.500,000 to Rs.5 million, and Rs.2,954 billion (3% of all non-food credit) was between Rs.5 million and Rs.10 million. This suggests that 38% of all non-food credit was most likely availed by individuals - a considerable market for individual loans.

The market for personal loans is growing faster than that of corporate loans. Figure 1 shows the YoY % change in credit disbursed by banks. The only category of loans that has seen an increase in disbursements are personal loans.

It is hard to estimate the size of loans from other sources, especially informal sources such as shops and friends and family. One estimate suggests that the micro-finance market is likely to grow at a double digit CAGR between 2018-2023.⁸

3.2 Stress is building

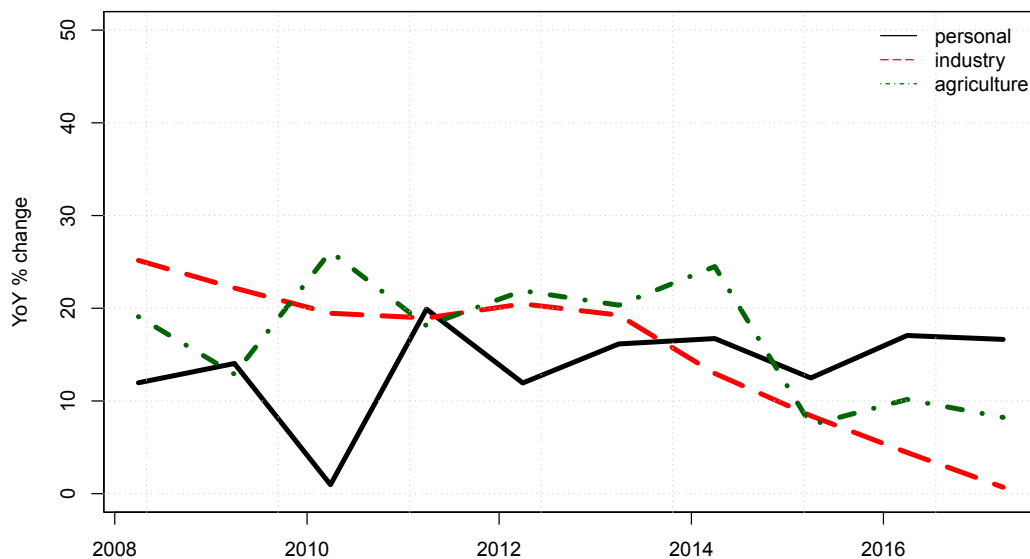
It is widely believed that the NPAs in the banking sector on personal loans are small relative to those on corporate loans and hence personal insolvency is less of a concern. However, there are signs of stress for the following reasons:

1. NPAs on housing loans, as well as education loans have seen to hit 12% and 9% respectively in the last few years.⁹ High growth rates in personal credit may imply higher NPAs in the near future.
2. Loans under priority sector also contribute to the total gross NPAs of the banking sector. In 2016-17, gross NPAs on the priority sector in 2016-17 were about 23% of the total NPAs.¹⁰ While this may seem small relative to NPA

⁸See <https://www.techsciresearch.com/report/india-microfinance-market/3210.html>

⁹See Kohli 2016, TOI 2018

¹⁰Gross Non-Performing Assets (NPAs) and Gross Advances by Priority and Non-priority Sectors: Domestic Scheduled Commercial Banks (excluding Foreign Banks), CMIE Economic Outlook.

Figure 1 YoY % change in credit disbursed by banks


Source: CMIE Economic Outlook

crisis in the infrastructure and power sector space that is dominating headlines currently, this has not always been the case. In 2012-13, priority sector NPAs accounted for 41% of total NPAs.

3. A growing cause for concern has been the lending on account of the “Kisan Credit Cards (KCC)”,¹¹ and loans under the Mudra scheme,¹² which are likely to have significant stress.¹³
4. As the credit market expands, and households build up exposure to different lenders, the problem of collective action in recovery will also become important.

From the perspective of households, little is known about the stress in their portfolios. While the media is dominated by stories of farmer suicides owing to inability to repay loans,¹⁴ or more recently by stories of farmer protests around the country,¹⁵ systematic evidence on the extent of borrower over-indebtedness as well

¹¹KCC scheme that was put in place in 1998, which provided farmers with easy credit without any collateral. The holder of the KCC could withdraw money upto Rs.50,000, from a bank and use it for any purpose. This also ruled out the possibility of banks monitoring the usage of the loans

¹²Mudra loans are given under the Pradhan Mantri Mudra Yojana is a Government of India to small business.

¹³See Kapoor and Yadav 2018

¹⁴Tiwarly 2017 reports that between 2015 and 2016, farmers suicides spiked by 41% and 80% of the suicides were because of bankruptcy or debts owed to banks and micro finance institutions.

¹⁵See <https://indianexpress.com/article/india/farmers-delhi-protest-live-updates-two->

as distress is not available. One estimate by Prathap and Khaitan 2016 who study financial diaries of 400 borrowers in the Krishnagiri district in Tamil Nadu points to 21% of the sample to be under serious financial stress owing to their debts. At the higher income spectrum, large number of corporate promoters have accessed credit on the basis of personal guarantees,¹⁶ that have now found themselves in the NCLT on account of corporate insolvency. These stories suggest that there is a wide range in the profile of borrowers who may be indebted, and their ability to access formal systems, or find the resources to make repayments may vary greatly.

3.3 Loan waivers are rising

On recovery, India has a long history of loan waiver programs. Sensational stories about poor people burdened under large amounts of debt from exploitative lenders gain traction in the political discourse. The largest of these was a Rs.760 billion farm debt waiver in 2008. The scheme was aimed at providing relief to farmers through a complete debt waiver to small and marginal farmers, and a partial relief to other farmers. More recently, several state governments of Uttar Pradesh, Maharashtra, Punjab have announced their own loan waiver schemes. The implementation of such schemes, however, leaves a lot to be desired. For example, a CAG report has demonstrated large scale mismanagement in the 2008 loan waiver scheme, including problems of exclusion in beneficiary lists, tampering of records, and forging of documents to claim benefits.¹⁷

Besides the obvious fiscal consequences of waivers, they create moral hazard problems which are detrimental to the development of a credit culture. If debtors expect that there will be a loan-waiver announcement in the future, then there is little incentive to repay on time, as has been demonstrated by empirical research.¹⁸ Loan waiver announcements are also believed to have caused a spike in NPAs.¹⁹ Anecdotes suggest that loan-waivers have contagion effects on other sources of credit such as micro-finance. Lenders (other than public sector banks that are forced to lend through priority sector lending targets described earlier) become wary of venturing into these markets making borrowers more credit constrained. Credit becomes more expensive for everyone, and not just those who benefited from the waiver.²⁰

day-march-demanding-special-parliament-session-5470020/

¹⁶See Bhageria 2017

¹⁷See Sane and Sapre 2017

¹⁸See Kanz 2016

¹⁹See The New Indian Express 2018

²⁰See Sane 2018

3.4 Legal processes for recovery are weak

Personal insolvency laws date back to the British times with the Presidency Towns Insolvency Act (PTIA), 1909 for Calcutta, Bombay and Madras and the Provincial Insolvency Act (PIA), 1920 for the rest of India, respectively. These laws have been used very rarely. The formal process of recovery has instead been through two legislation's:²¹

1. *Negotiable Instruments Act, 1881*: While the NI Act, 1881 has been around since British times, the Act became an important tool for credit recovery when Section 138 was added in 1988 which criminalised a “bounced” check.²² The lender could collect post-dated checks from the borrower, and if the borrower's check did not clear, then the lender could pursue criminal action against the borrower. Khanna 2017 reports that lenders (in the home mortgage market) started using this provision in the mid 1990s as there were very few other alternatives. The *process* of taking the debtor through the NI Act itself served as a deterrent to default. Even today, most NBFCs that are active in making loans to individuals - either for commercial or consumption purposes - resort to using Section 138 of the NI Act.
2. *SARFAESI, 2002*: The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Act (SARFAESI), 2002 provided sweeping powers to banks and financial institutions to recover against non-performing loans by taking possession of collateral security without court intervention. However, SARFAESI is useful to only one class of creditors (banks and financial institutions that provide secured loans). Also, its efficiency has been falling over time - by 2013 the recovery rate was down to 22% from 61% in 2008.²³

While the two laws have existed on paper, and Section 138 of the NI Act, 1881 used quite frequently, the effectiveness of the laws is hampered by the inefficiency of the Indian judicial system, which gets worse on matters related to property, contracts and mortgages.²⁴ For example, while SARFAESI was successful in the beginning, over time, the recovery rates had begun to decline. It is also important to note that these processes are available only to a certain class of creditors - banks and financial institutions. A large category of other creditors do not find themselves with any mechanism for recovery.

²¹While the Debt Recovery Tribunals are another mechanism, they apply only to loans worth Rs.10 lakh and more, and hence are largely used for corporate insolvency

²²See Malhotra 2009

²³RBI Report on Trends and Progress in Banking in India, 2008-2013.

²⁴Khanna 2017 mentions the discussions on this issue in several Law Commission of India reports (No. 14, 79, 124, 230 and 245)

3.5 Coercive collection is prevalent

Ineffective legal procedures led to lenders using intimidating tactics to recover their loans. The RBI issued a circular on Guidelines on *fair practices code for lenders*, dated May 5, 2003 that dealt with matters of recovery of loans and directed that lenders should not resort to undue harassment viz. persistently bothering the borrowers at odd hours, or use muscle power for recovery of loans.²⁵ Such incidents resurfaced during the recession caused by the 2008 global financial crisis. Persons were hit by loss of jobs that resulted in EMI defaults on credit cards, housing mortgages, consumer and personal loans. Financial institutions resorted to recovery of loans through muscle men, who even carried out physical assault. Court Orders were passed to stop banks using muscle men.²⁶ The RBI put out another circular on 26 March 2012 outlining a *fair practices code for NBFCs* that also emphasised refraining from coercive collection practices.²⁷

Similar incidents on borrower distress and creditor excess have been seen in the context of micro-finance as well. In 2010, several suicides in the state of Andhra Pradesh were allegedly caused by coercive recovery practices of micro-finance institutions (MFIs), leading the state government to effectively ban MFIs in the state, and the RBI to intervene by creating a separate category for NBFC-MFIs and imposing several micro-prudential requirements on them.²⁸

3.6 This has an adverse impact on the credit market

The lack of a framework to resolve personal insolvency has had two broad effects. The first is on the structure of credit markets.²⁹ It is quite likely that the problem of financial exclusion is as much a result of poor frameworks for recovery as information symmetry. The cost of capital is higher if lenders do not feel confident about their ability to recover their dues, leading to informal sources such as shops, and friends as family filling the gap as was seen in Table 1. The non-existence of an insolvency framework has also led to a preponderance of collateralised lending, which exacerbates the problems of financial exclusion. Individuals have remained credit constrained, as the market is not willing to take a chance on those without a significant credit history or collateral, thus perpetuating the cycle.

Another effect has been an emergence of businesses that modeled themselves around “joint-liability groups”, where loans are given to groups as opposed

²⁵See RBI 2003

²⁶<http://taxguru.in/corporate-law/preview-on-insolvency-and-bankruptcy-with-reference-to-individuals-and-corporates.html>

²⁷See RBI 2012

²⁸Sane and Thomas 2013 provide a brief overview of the micro finance crisis and argue the need for better consumer protection frameworks in the collection of debts.

²⁹World Bank 2017 presents a case on the importance of personal insolvency for the MSME sector.

to individuals. Pressure from group members solves for both information asymmetry and serves as a disincentive to default, solving the collection problem. While micro-credit has, in some ways, revolutionised access to credit for those in the lower income bracket, it is not without its costs.

The second is the effect on borrowers. Coercive collection practices can have significant physical as well as psychological costs on debtors. It also leads to political pressure to take action - in the form of bans on certain forms of credit,³⁰ or in the form of loan waivers - which only exacerbates the problems of low credit access, and leads to further distortions in markets. Without personal insolvency procedures debtors have very limited opportunities of re-negotiation with their creditors if they see a chance of saving their businesses as a going concern.³¹

Finally, the lack of a sound process has meant that debtors have no mechanism of getting effective relief from collection, where one chapter of default can be closed, and the debtor can begin with a “clean slate”, and return to productive work. The lack of such “insurance” makes debtors more likely to become risk-averse, less willing to borrow, thus having an impact on entrepreneurship in the economy.³²

4 An overview of personal insolvency in the IBC

The report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design claimed to be concerned about the adverse impact of lack of recovery frameworks on the credit market and hence, was motivated by the potential impact a personal insolvency law could have on the same. Towards this end, the BLRC articulated the following goals:

1. *Providing a fair and orderly process for dealing with the financial affairs of insolvent individuals:* The BLRC suggested that active participation by stakeholders required that the process of re-negotiation be fair and orderly. This is related to the idea that the process should enable both debtor and creditor to participate with the least possible delay and expense, and there to be a certain predictability to the outcome.
2. *Providing effective relief or release from the financial liabilities and obligations of the insolvent:* There was recognition by the BLRC of the idea that the debtor will only meaningfully participate in the process if participation will

³⁰For example, in 2010 the Andhra Pradesh government brought an ordinance effectively banning micro-finance in the state in response to alleged suicides caused because of coercive collection by micro-finance. See Sane and Thomas 2016 for the impact of this Ordinance on consumers.

³¹An example of this is described by Ameerudheen 2018 on recovery proceedings under the SARFAESI Act, 2002 in the past two years against cashew farmers in Kerala.

³²See Feibelman 2005 for a discussion on the insurance function of bankruptcy.

allow for the possibility of discharging all debt. This chance at discharge might encourage households to take more risk and engage in entrepreneurial ventures.

3. *Providing the correct ex-ante incentives:* The participants in the process will naturally want to maximise their own value first. The BLRC was of the view that it was likely that either the creditors or the debtor would game the system to their own advantage. This could skew incentives and lead to a poor credit market. The processes, therefore, need to be designed such that individuals are not able to unfairly strategise during the process of bankruptcy.

These objectives have been the guiding principles behind the design of personal insolvency in the IBC. While the IBC does discuss the importance of providing the debtor with a clean discharge from debts, it seems to be less motivated by the need of bankruptcy law to also provide an element of insurance, with the emphasis being on discharged that is “earned”.³³ With this background, the section turns towards a description of the defining features of personal insolvency law in the IBC.³⁴

4.1 Eligibility

There are three ways to think about eligibility into the IBC process: a) the threshold at which a filing can be made, b) entities who make the filing, and c) the debt that qualifies for a filing.

The eligibility threshold for filing in the IBC is low - a single default of at least Rs.1,000 would suffice. The Code makes it possible for the government to raise this to Rs.1,00,000 but not higher.³⁵

The IBC permits either the debtor defined as an individual or partnership firm, or the creditor to file for insolvency. However, for the process of “Fresh Start”, discussed later in this section, only the debtor is eligible. A creditor includes a financial, operational, secured, unsecured creditor as well as a decree holder.³⁶ This suggests that that all kinds of creditors including moneylenders, friends and family could technically file for insolvency.

Finally, a filing can be made only on default of debt that is not excluded. The IBC includes the following in its category of excluded debts - liabilities for court or tribunal fines, maintenance of any person required by law, student loans, negligence, nuisance or breach of a statutory contractual or other legal obligations. The Code leaves open the possibility that regulations will specify other kinds of debts in the class of excluded debts.³⁷

³³See Feibelman 2005 and Feibelman 2018

³⁴Feibelman 2018 provides an excellent summary of the provisions of the Code.

³⁵Section 78, IBC

³⁶Section 3(10), IBC

³⁷Section 79(15), IBC

4.2 Processes

The IBC has two kinds of processes. The first is the route of the “insolvency resolution process” followed by “bankruptcy”. The second is the route of a debt-waiver through the “fresh start”. The choice of the route depends on specific eligibility criteria, and the IRP-bankruptcy route seems to be the preferred route for most insolvencies.

4.2.1 The IRP-bankruptcy route

The Insolvency Resolution Process (IRP) is the process through which all creditors and the debtor agree on a negotiated repayment plan.³⁸ The IRP can be initiated by the debtor or the creditor at the relevant DRT, through an application the form and manner of which will be prescribed by regulations. The application is to be examined by a Resolution Professional (RP) who is responsible for making a recommendation of acceptance or rejection to the DRT.³⁹

Once the IRP application has been accepted, a moratorium of six months would commence on all collection actions.⁴⁰ A public notice is to be issued by the DRT, and creditor claims are to be collected by the RP.⁴¹ The debtor is required to propose a repayment plan under the supervision of a RP, which should meet the approval of majority of creditors, defined as more than three-fourth in value.⁴² Once approved by the creditors and sanctioned by the adjudicating authority, the plan would be binding on the debtor and all the creditors mentioned in the plan. The IBC provides no guidance on the content of the plan, or require the plan to provide for at least a minimum living standard for the debtor. These details might get drafted in the regulations that would govern the process. However, it requires that the consent of the debtor is mandatory for any modifications to the plan the creditors may suggest.⁴³ The IBC thus balances the propensity in India of the law and regulations to micro-manage every process with the welfare of the debtor.

The approved plan has to be submitted to the DRT who then passes a final order on the plan.⁴⁴ The implementation of the plan is to be supervised by the RP. A discharge order may be granted to the debtor in accordance with the content of the resolution plan.⁴⁵

The IBC envisages three grounds for failure of the IRP which can lead to bankruptcy proceedings: (a) If the application to the IRP is not accepted due

³⁸Chapter III, Part III, IBC

³⁹Section 99, IBC

⁴⁰Section 101, IBC

⁴¹Sections 102, 103 and 104, IBC

⁴²Section 111, IBC

⁴³Section 108(3), IBC

⁴⁴Section 114, IBC

⁴⁵Section 116, IBC

to failure to provide requisite information, (b) If creditors and the debtor cannot agree on a repayment plan, and (c) If the debtor fails to implement the repayment plan within the period prescribed for such implementation in the plan.⁴⁶ The bankruptcy proceeding will not start automatically: the creditor or the debtor would have to make an application to trigger it. The rationale for this lies in the higher stigma attached to an individual's bankrupt status.

On the admission of the application for bankruptcy, an insolvency professional will be nominated as the bankruptcy trustee by the IBBI if either the debtor or creditor has failed to propose one.⁴⁷ A bankruptcy order will be passed by the DRT.⁴⁸ It will have the effect of declaring the debtor as 'bankrupt' and vesting the estate of the bankrupt with the bankruptcy trustee.⁴⁹ A certain class of assets of the debtor would remain outside the estate such as property held by the bankrupt on trust for any other person, sums due to workmen or employees from the provident or pension fund, and assets that may be specified by the Central Government or a financial sector regulator.⁵⁰ On the vesting of the estate of the bankrupt, the bankruptcy trustee will undertake the due process for registering claims, and administering them in the order of priority encapsulated in the IBC.⁵¹

For both of these processes, the Code does not specify fees for filing either the IRP or bankruptcy and leaves open the possibility that the fees may be prescribed later.⁵² Fees to the insolvency profession in the IRP as well as bankruptcy are expected to be accommodated in the respective procedures.⁵³

4.2.2 The Fresh Start route

The IBC proposes a concept of a Fresh Start, aimed at providing debt relief to the poorest. A debtor with gross annual income of less than Rs.60,000, assets less than Rs.20,000, qualifying debts⁵⁴ of less than Rs.35,000, and no home-ownership, will be eligible to get a complete waiver of debts.⁵⁵

Only the debtor can trigger this process.⁵⁶ The default has to be on "qualifying debts". If the debtor has triggered the process through a resolution professional,

⁴⁶Section 121, IBC

⁴⁷Section 125, IBC

⁴⁸Section 126, IBC

⁴⁹Section 128, IBC, Section 154, IBC.

⁵⁰Section 155, IBC

⁵¹Sections 129-137, IBC; Section 178, IBC

⁵²Section 94(6), IBC

⁵³Section 105(2)(b), and Section 178, IBC.

⁵⁴Qualifying debt includes debt that is due for repayment provided it is not part of the excluded debt category, is not secured, and has been incurred three months before the fresh start application. See Section 79(19) of the IBC.

⁵⁵These thresholds have been designed using the SECC, 2011, Deprivation Index as well as the Key Indicators of Debt and Investment in India for 2013 and will need to get revised over time.

⁵⁶Section 80, IBC

then the DRT will only check if there is a disciplinary proceeding against the RP, and allow the RP if no such proceeding is found. If the debtor triggers the process without an RP, then the IBBI will be required to nominate a RP for the process.⁵⁷ The Code specifies a list of particulars that must be submitted with the application.⁵⁸

On examination of the information, the RP will make a recommendation to the DRT to accept or reject the application.⁵⁹ The DRT will accept the application based on the RPs recommendation.⁶⁰ A moratorium will become applicable on all the creditors of the applicant for a period of six months, to provide a conducive environment for the process to go through.⁶¹ The DRT shall pass a discharge order for the qualifying debts by the end of the moratorium period.⁶² The details of the discharge order will be forwarded to the IBBI for record-keeping.⁶³

The motivation behind the fresh start seems to be the difficulties in the transaction costs of the IRP-bankruptcy route being larger than the debt at stake for low-income, low-asset debtors. The fresh start also provides an insurance function⁶⁴ by essentially providing a more systematic debt-waiver.

4.3 Role of secured creditors

In individual insolvency, secured creditors are permitted to stay out of the IRP entirely by enforcing their security interest, unlike the provisions in corporate insolvency. The secured creditors are required to submit an affidavit to this effect to the RP, and if the same lender has also extended unsecured credit, then participate in the voting process only to the extent of the same.⁶⁵ The BLRCs argument was that unlike a firm where organisational capital is better preserved when all the assets, including those put up as collateral, hang together, in the case of an individual this is less important. It is the individual herself that is the repository of the capital (human capital).

Once a bankruptcy order is passed, and the estate is vested with the bankruptcy trustee, a moratorium will begin, on all collection actions of unsecured creditors. Secured creditors will have the option to participate in the process or enforce their security outside the process.⁶⁶

⁵⁷Section 82, IBC

⁵⁸Section 81(4)

⁵⁹Section 83, IBC

⁶⁰Section 84, IBC

⁶¹Section 84, IBC

⁶²Section 92, IBC

⁶³Section 92(5)

⁶⁴See Feibelman 2005

⁶⁵Section 110, IBC

⁶⁶Section 172, IBC

4.4 Priority

In the IBC, there is no priority in the design of the repayment plan. There is, however, a priority in bankruptcy as follows.⁶⁷

1. The costs and expenses incurred by the bankruptcy trustee
2. Workmen's dues for a period of 24 months prior to the bankruptcy commencement date
3. Wages and unpaid dues owed to employees (other than workmen) for a period of 24 months prior to the bankruptcy commencement date
4. Amount due to the Central or State Government.
5. All other debts owed by the bankrupt include unsecured debts.

While this list provides a ranking between various classes of debt, the IBC requires that all debts within one class shall rank equally among themselves. Feibelman 2018 notes that this is problematic.

4.5 The role of the DRT

The role of the Tribunal is wider in personal insolvency relative to corporate insolvency. For example, once the IRP has been triggered, the DRT is responsible for accepting the application on the basis of the report submitted by the RP.⁶⁸ The law does not provide any guidance on what the DRT should base its judgment on, and whether it should solely rely on the recommendations of the RP. If the RP requests, the DRT may also provide instructions for the conduct of negotiations between the debtor and creditors.⁶⁹

Similarly when the repayment plan is submitted by the RP to the DRT, it may accept or reject the plan on the basis of the report. The DRT, in its order of approving the plan, may provide for directions for implementing the plan, or may direct the RP to re-convene a meeting of creditors if it feels that the repayment plan requires modification.⁷⁰

The DRT also has a role to play when deciding about priority of payments in a bankruptcy in specific cases related to creditor having given any indemnity or having made payments through which the bankrupt has been protected. In such an event the Code allows the DRT to give that specific creditor an advantage over other creditors.⁷¹ Through these provisions, the DRT may actually end up playing a far greater role in the conduct of the IRP relative to the corporate insolvency process, and what was envisaged by the BLRC.

⁶⁷Section 178, IBC

⁶⁸Section 100(1), IBC

⁶⁹Section 100(2), IBC

⁷⁰Section 114, IBC

⁷¹Section 178(3), IBC.

5 The way forward

Personal insolvency in the IBC, when notified, will become operational in a credit market that has evolved over several decades in response to an environment with weak creditor rights on recovery, and weaker debtor rights on stalling creditor enforcement. The credit market is also politicised, especially when it comes to agricultural lending and loan waivers.

The enthusiasm of these existing creditors will depend on how the IBC affects their costs and time to recovery, as well as recovery rates. Of course, it is possible that the law leads to the evolution of new business models and new class of lenders who now feel comfortable entering the market, but this will unfold over the longer term and will also be a function of a demonstration effect based on the experience of the existing market participants.

From a debtors perspective, the IBC provides a tool for dealing with distress that is currently unavailable. By permitting the debtor to file for insolvency, the IBC provides a legal mechanism to debtors to bring about a stay on enforcement actions. It also provides a platform for debtors to be able to re-negotiate their plan, which may be extremely useful, if the debtor has more than one creditor. The fresh start provisions, especially, may be extremely useful for the debtor to avail of a loan-waiver.

For the debtors to be able to use the IBC, two facets are extremely important. First, if there is a social stigma associated with the bankruptcy process then it is unlikely that debtors will take recourse even if it might be in their economic interest to do so. Second, if the process of accessing the law is costly and cumbersome, is seen to be “creditor friendly”, or if the process does not provide a reasonable mechanism of dealing with creditors while maintaining a minimum standard of living then debtors might not find it worthwhile to pursue this course of action. Much, therefore, depends on the regulatory environment and institutional infrastructure that governs the process. The section turns to issues that need to be resolved before the law can be meaningfully implemented.

5.1 Policy issues

Personal insolvency laws affect both the creditors and debtors in different ways, and must strike a balance between both their interests. From a debtors perspective, personal insolvency must provide a stay collection of an individual debtor’s obligations, provide for a scheme of repayment, and finally discharge some obligations. A process that is humane, fair, and offers debt-relief can significantly reduce psychological distress among debtors, and encourage risk taking and entrepreneurship. On the other hand, if the process provides for significant debt relief at the

cost of creditors, then creditors will eventually pass on high costs of credit back to the debtors. The process also has to provide creditors with reasonable recovery rates for them to be comfortable to lend in the future. The Act and the Regulations must provide for this balance.⁷² Before decisions are taken on amendments to the law or drafting of regulations, policy needs to be formulated that, at the very least, builds on the following elements:⁷³

1. *Definitions of assets and income:* The selection of debtors into a fresh start, or an IRP depends on the the definition of assets and income of the debtors. As of now, the thresholds for eligibility into the Fresh Start are hard coded into the law. It might be useful to take a re-look at the relevance of the thresholds from the perspective of making the process more debtor friendly, and increasing the thresholds so that a larger number of people may be eligible. It is also important to link these thresholds to some index so that the thresholds are in sync with GDP growth as well as inflation.

For the IRP or bankruptcy process, the recovery of creditors will depend on what assets remain exempt from the insolvency process (for example, some share of property, tools of trade that allow him to gain and pursue employment, and items necessary to meet a certain minimum standard of living), and what part of the disposable income is deemed to be “reasonably necessary” for the maintenance or support of the debtor and her dependents. This requires a discussion on the definition of such assets and income.

2. *Structure of repayment plans:* The IBC provides for no structure on the repayment plan, as well as no guidance on priority in the IRP. As Feibelman 2018 has pointed out, the inconsistency in the priority in an IRP and bankruptcy might incentivise creditors to choose one over the other, which in some instances may be counter-productive, especially if there might be value in saving a small firm as a going concern. Policy also needs to consider prohibiting repayment plans from including onerous terms as well as provisions on extortionate transactions and preferential transfers.
3. *Fast track procedures through a non-judicial entity:* For a large number of cases, there might be merit in developing “fast track procedures” that involve obtaining quick relief. One example is to provide a standard “three year repayment plan”, wherein debtors commit to provide a part of their income to creditors in return for a complete discharge of debts. The challenge in this procedure is going to be the design of eligibility into the plan - a demonstra-

⁷²The IBBI published draft regulations on personal insolvency in December 2017. While these regulations provided the details for a broad process to be followed, they were not accompanied by a broad objective and goals that the regulations wished to achieve.

⁷³World Bank 2014 provides a comprehensive analysis of the various choices regarding a personal insolvency regime.

tion that debtors have the ability to part with a share of income while still maintaining a reasonable standard of living will have to be made. This process is likely to be fraught with challenges, and disputes.

An alternative option is to present a standardised repayment plan that promises a specified recovery rate. The debtor promises to repay this amount over a period of time. While this may imply that in some cases creditors make lower recoveries than they otherwise would, on the whole, it reduces the cost of discovery, of negotiation and of potential litigation. It should be possible to offer this as an alternative through an administrative agency and not the court. At the very least, a policy decision on such alternatives needs to be articulated.

4. *Processes for loan waivers*: The Fresh Start process aims to provide complete debt relief to people who fall below certain asset, income and debt thresholds. This process can provide a way to carry out loan waivers in a more systematic way.⁷⁴ The details of implementing loan-waivers through the fresh start process need to be thought through.
5. *Discharge and credit scores*: The IBC allows for a discharge while the repayment plan is still in progress. Similarly, it allows for availing complete debt relief for those eligible under the Fresh Start. These decisions should come at some cost to debtors to reduce the possibility of moral hazard. This can be done through a system of records where these choices of debtors are stored for a specified number of years - providing creditors with information on whether to extend credit, and at what price. The processes for the collection and maintenance of these records, and their integration with the credit bureaus need to be designed.
6. *Fees*: The IBC is silent about the fees of the two processes. It is expected that the fees to the professionals (as well as the court) will be accommodated in the repayment plan that is agreed on, or the bankruptcy estate that is liquidated. This leaves the question of how to deal with a large number of cases that have no income, and no assets and could possibly not afford the IBC processes. These may be paid out of a fund that is maintained by the IBBI from fees charged to regulated entities, through general tax revenues or alternatively such cases be not be admitted at all. The trade-offs between these alternatives need to be revisited.

5.2 Institutional infrastructure: Courts

Unlike corporate insolvency, the IBC design suggests a far greater role for the DRTs in the process, placing greater demands on the judiciary. The problems with

⁷⁴Sane 2018 for a description of how loan-waivers can be carried out through the fresh start process in the IBC.

judicial inefficiency in India are not new. While tribunals were created to bypass the long-winded processes of the civil courts, they too have not lived up to their expectations.⁷⁵ The inefficiency is on account of the “quantity” of judges, as well as the “quality” of the process wherein a large proportion of the judges time is spent in administrative matters leaving little time for judicial decisions.⁷⁶

The quantity aspect assumes more importance in personal insolvency as it is expected that people from all parts of the country should be able to access the system. For example, Sane 2017 finds that the case load on existing DRTs will rise significantly even if 1% of personal loan accounts at banks in a district were to default, and just under 10% of these were to be brought under the IBC. This is a very conservative estimate as this only includes credit extended by the banking sector. The potential case load from personal insolvency cases is a concern as there were already a 109,518 cases pending at the DRTs as of 30 June 2017.

Besides increasing the number of DRTs, the processes within the DRTs needs review. As has been pointed out by Datta 2016, a “Tribunal Service Agency” needs to be set up which will provide administrative support to the Tribunals. This will lead to a separation between the administrative and judicial functions, and allow the judges to spend more time on the latter.⁷⁷ These reforms are particularly important if the DRTs have to become a meaningful adjudicating authority for personal insolvency.

5.3 Institutional infrastructure: Information utility

A key problem in the implementation of any insolvency regime, and personal insolvency in particular, is that of “asset legibility”. It is extremely difficult for the creditor, or the resolution professional to evaluate the exact nature and value of a debtors assets to arrive at an acceptable repayment plan, or liquidation value in case of bankruptcy. A core component of the BLRC recommendation was the idea of an “Information Utility” which would be a repository of information regarding debt and default. The IBBI issued regulations on IUs in March, 2017. Since the regulations, only one IU, the National E-Governance Services Limited, has been established. It is extremely important to understand the reasons for the reluctance of private entities to establish IUs and make corrections in the regulations⁷⁸ in order

⁷⁵The Supreme Court, in *L. Chandra Kumar vs. Union of India*, 1997 lamented that Indian tribunals function inefficiently since there is no authority in charge of supervising and fulfilling their administrative requirements.

⁷⁶Damle and Regy 2017 show the shortfall in the number of judges in the NCLT in the context of the increasing case load from the IBC. Datta and Shah 2015 point out the mistakes made in India on court modernisation.

⁷⁷A similar suggestion was made by the FSAT Task Force led by Justice N. K. Sodhi, in 2015, to provide administrative services to tribunals in financial sector.

⁷⁸See Prashant et. al. 2017 for a critique of the IU regulations.

to promote the setting up such an industry.

5.4 Institutional infrastructure: Intermediaries

Individual debtors will be vulnerable to biased advice on whether to file for insolvency, the process guiding the filing, and the process for resolution, as well as in their dealings with creditors. In other sectors in retail finance in India, there have been various instances of mis-selling that have arisen from a combination of misaligned incentives that stem from high powered sales practices combined with weak regulation.⁷⁹ If not handled correctly, such problems are likely to occur in the field of personal insolvency as well. The IBBI will have to step up to the challenge of protecting customer interests, involving two main class of intermediaries: the insolvency professionals and credit counselors.

5.4.1 Insolvency Professionals

Insolvency professionals have a very important role to play in the IBC. In the case of corporate insolvency, as “Resolution Professionals” they run the entire resolution process, and in liquidation act as the “liquidator”. The role of the insolvency professional is even more important in the case of personal insolvency owing to the asymmetry in the balance of power between creditors and debtors. Several important decisions on filing, preparing a plan, preparing a statement of affairs, negotiating with creditors, which will be fundamental to the experience of the debtors in the Code, depend on the integrity and efficiency of the resolution professional.

Currently there are about 2000 IPs registered with the IBBI for corporate insolvency. They are regulated through self-regulated organisations called the Insolvency Professional Agencies (IPA), which are in turn regulated by the IBBI.⁸⁰ There have been many challenges in the functioning of RPs in the case of corporate insolvency - from allegations of partisan behaviour, questions around appropriate timelines, to attacks and kidnappings of the RPs.⁸¹ It is likely that frictions between the various stake-holders to the debt contract and the RPs will increase when it comes to personal insolvency. Even if the disputes end up being of small values, they are likely to be more political should misconduct be discovered.

The training and qualifications of IPs, and their regulation will require concerted efforts from the IBBI with a specific focus on the problems that can arise

⁷⁹See Anagol and Kim 2012, Halan, Sane, and Thomas 2014, Sane and Halan 2017, Anagol, Cole, and Sarkar 2017 for examples of consumer protection problems in the insurance and mutual fund industries in India.

⁸⁰Existing professional organisations such as the Institute of Chartered Accounts of India (ICAI), Institute of Company Secretaries of India (ICSI), and Institute of Cost Accountants of India (ICWAI) have been given the license to perform as IPAs.

⁸¹See Vats 2018, Gopakumar and Upadhyay 2017 for more details.

in personal insolvency. It is unlikely that the regulations that serve the purpose of corporate insolvency will work for personal insolvency. For example, a trade-off that the IBBI may have to evaluate is simple licensing procedure so that there are enough RPs to service individuals across India versus a minimum standard of qualifications to ensure service quality. Similarly, mechanisms to discipline a large cadre of professionals will require an enforcement capacity that may be currently missing.

5.4.2 Credit and insolvency advisors

The decision to file under the IBC is a complex one. It is expected that debtors will require advice on questions such as whether to file for insolvency, where to file, what to expect in the process, how to find the RPs, when to expect a discharge, and the impact of the process on their credit scores and future ability to raise debt. Given the potential social stigma that may get attached to bankruptcy, the hand-holding required may be greater.

In several jurisdictions, this is done through a class of intermediaries called as “credit counselors”, or “debt-advisors”. In the US, for example, the Bankruptcy Abuse and Prevention and Consumer Protection Act (BAPCPA) 2005 requires the individual to obtain credit counseling from an approved counseling agency⁸² within 180 days preceding a bankruptcy filing. It also requires the debtor to go through a post-petition financial management course. Failure to get counseling may lead the case to be dismissed. The agencies get regulated primarily by the Federal Trade Commission (FTC) and the US Trustee Program at the Department of Justice. In the UK, “debt advice” is not mandatory. Multiple debt advice agencies, regulated by the Financial Conduct Authority (FCA), provide help in exploring various avenues of insolvency resolution. Individuals are encouraged to go through these advisers to make an informed decision. The application for a debt waiver in the UK (through a debt relief order which is similar to the Fresh Start in the IBC), must be made through such approved intermediaries.

The IBC is entirely silent on the need for credit and insolvency advisors. However, the draft regulations by the IBBI mention the need to have debt counselors, but the regulations do not specify any details. It is non-trivial to get the regulations right - for example Kilborn 2011 claims that the BAPCPA reforms that made credit counseling mandatory also put a cap on fees that has resulted in “ceremonial” counseling which is ritual devoid of any substance.

⁸²These are not-for-profit agencies set up to advise and educate consumers on financial portfolio management.

6 Conclusion

Credit markets are important from the perspective of growth. A well functioning credit market allows for consumption smoothing, and facilitates entrepreneurship. Insolvency laws play an important role in facilitating the growth of credit markets.

This paper presents an argument for the need for a personal insolvency law in India. It provides a brief overview of the provisions on personal insolvency in the Insolvency and Bankruptcy Code, 2016, that have yet to be notified. The paper raises several policy issues that need to be addressed, and makes the case that the success of the IBC depends on the design of the subordinate legislation as well as the evolution of the institutional infrastructure. High quality regulations, improvements in the functioning of the institutional infrastructure such as the Information Utilities and Debt Recovery Tribunals, the insolvency professionals, advisory services for bankruptcy are critical for personal insolvency to have its effect.

As has argued by Shah 2018, “state capacity building requires sequencing, where the ecosystem learns to deal with simple things before taking on the complex problems.” The idea is that the reform process should always be mindful of the load bearing capacity of public administration⁸³, and prematurely increasing the complexity of the ask, might actually lead to a low-equilibrium outcome.⁸⁴ These issues are extremely relevant in the context of personal insolvency where the issue is complex in and of itself, and is susceptible to political interference should there be mistakes early on. It would, therefore, be advisable to operate the system for a small subset of borrowers such as businesses, or personal guarantors before becoming operational for all individuals. Alternatively, the IBC can be made operational for granting debt relief more systematically through the Fresh Start process, before operationalising the resolution and bankruptcy processes.

⁸³See Shah 2017

⁸⁴Rai 2018 makes this argument in the context of the design of a privacy law.

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