Indian banks’ Now What? moment

The threat of bankruptcy and insolvency is a strong and credible deterrent to corporate and individual delinquencies. But to a point. The situation after insolvency proceedings have actually initiated against a defaulting corporate is far more nuanced.

Data on the outcome of insolvency proceedings, the world over, is voluminous. There is little consensus among academics on the overall efficacy of court-monitored resolution mechanisms. The one strand that survives decades of analysis of such cases in the US is that Chapter 11 proceedings had a “huge failure rate.” The celebrated Chapter 11 of the U.S. Bankruptcy Code favors the reorganisation and rehabilitation of all financially troubled companies that are deemed to be worth saving—in other words, worth more as going concerns than liquidated in piecemeal form. In the 1960s, the Brookings Institute had estimated that the Bankruptcy Act of 1898 had produced successful reorganizations in about 33% of business cases. The one-third success rate was obviously considered dismal and prompted a review of Chapter 11 in the Bankruptcy Reform Act of 1978. A subsequent study by the Administrative Office of the U.S. Courts said the success rate had indeed halved from one-in-three to one-in-six, cementing the conventional wisdom that Chapter 11 was a high failure mechanism.

Privately, Indian bankers have not been too enthusiastic about the Indian Bankruptcy Code and the court supervised proceedings that it entails. The outcome of a recent case has definitely not helped. In the case of Synergies-Dooray Automotive, said to be the first case disposed off by the National Company Law Tribunal (NCLT) under the Insolvency and Bankruptcy Code, 2016 (IBC), creditors had to settle for Rs 54 crore as against their claims of Rs 972 crore.

In what follows, we roll out a mind game. It is a game theoretic view on why insolvency proceedings, as a court-mandated auction process, suffer from severe infirmities. Game theory models situations of interdependence where discrete choices are made by a small number of parties based on their assumptions of how their opponents will react. It will be useful to bear in mind that the use case here is of a company which is valued more as a going concern than the sum of its parts.

Let us begin with a corporate A whose last known bid for renegotiation of its outstanding loans with its creditors was at 60%. This means–assuming good faith–that corporate was certain its cash flows would be able to service debt if the total stock of debt was cut down to 60%. Of course there is no guarantee that the proposed restructuring plan would work over a long period of time and that the corporate would not have made another error of judgement. But lets us work on the premise that the creditor-banks could not agree to a 40% haircut, and had no option but to initiate IBC proceedings.

Now, Corporate B, looking at the same scenario, rationally infers that creditors are desperate for a better outcome (lesser haircut). Beyond that, Corporate B is faced with an information asymmetry conundrum.

One, Corporate B argues to itself (rationally, of course) that the debtor (defaulting company) must not be cooperating with the bank-led restructuring efforts till date for some reason. And that reason(s) have to be pretty strong that the asset had to be pushed into IBC resolution framework. It could be that the debtor has superior knowledge of a failing in the business plan, market potential, or the competitiveness of its products etc. and therefore, is desperate for a reduced level of debt which could be serviced under the “true and fair” business assumptions. Or, it could be that the gold plating in the project cost is so large that creditors are wary of acknowledging they knew of the inflated project projections and are therefore, not willing to budge.

Be as it may, for the purpose of this game at this time step, Corporate B prices in this large dollop of uncertainty by pricing the loan stock at 50%, say. That means, it asks the creditors to take a 50% haircut.

The next step becomes more intriguing. Corporate C has firm knowledge that the deal was not closed at a 40% haircut, and that Corporate B is in the game with a 50% offer. Now, it follows that any offer of more than a 50% haircut would be a waste of company time and energy because it is guaranteed not to succeed. Corporate C, therefore, rationally, bids at a 49% haircut. At that level, Corporate C is still in the game, though no better in information terms than Corporate B. The only additional data point with Corporate C is that Corporate B has bid at 50%. That data point is valuable because Corporate C rationally assumes that Corporate B has made a rational call at 50%.

As the game unrolls over several steps, the value of the discount–the haircut for the creditors–approaches 40%, the same level at which the negotiations for the original debtor, Corporate A, failed.

This is the case of a sequential game. The case for simultaneous bidding is a trivial extension as all bidders start with the same information asymmetry as Corporate B; all bids will be southwards of Corporate A’s 40% offer of a 40% haircut.

Why, you may ask, would a corporate M not offer a better price (lower haircut)? To figure that, one must traverse two streams. One stream links to an option where Corporate M has the option of setting up a greenfield capacity of the same template capacity. This choice entails costs of obtaining a plethora of clearances, acquiring land and setting up the plant, apart from the notional loss of sales during the construction period. On the plus side, given continuous improvements in technology, it can be assumed that the operating costs per unit of output will be lower than that of legacy plants. The balance between higher capex costs and lower operating costs cannot be ascertained *ab initio*. It will vary from industry to industry. In technical terms, the outcome is not deterministic, but stochastic. A small change in some operating variable could lead to vastly different outcomes.

Assuming Corporate M makes a bid decision, the second stream to traverse is the optimum debt that will be justified by the template production. The state of the industry, global demand and supply patterns etc. are common knowledge. Perforce, Corporate M cannot come to a conclusion of the appropriate debt level any better than the owner-debtor, Corporate A. Indeed, Corporate M’s optimum level of debt will be lower because it enters in the self-belief that it has superior skills in some form which will enable it to extract greater efficiencies from the plant that Corporate A could.

Unfortunately, in this theoretical gameplay, chances are slim that any intervenor will present a better value to banks than the original owner-debtor Corporate A. All of which leaves us wondering, much alike Bloat–one of the original inhabitants of the Sydney dentist’s fish tank in Finding Nemo(2003)– ‘Now What?’

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