Navigating India's Credit Evolution: Addressing Post-IBC Challenges and Opportunities

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Abstract: The introduction of the Insolvency and Bankruptcy Code (IBC) in 2016 marked a paradigm shift in India's financial landscape, aiming to resolve the twin balance sheet problem and revitalize bank lending. While the IBC has been effective in reducing NPAs and improving bank balance sheets, it has also reshaped India's credit ecosystem in terms sectoral deployment. This paper examines the unintended consequences of IBC, including increased risk aversion by banks, a decline in credit to industries, and the concurrent rise of NBFCs and consumer loans. Through an analysis of lending trends, we highlight the shift in credit flow from industry to personal loans and the risks posed by the growing reliance on unsecured consumer credit. The next half decade will be crucial in determining whether such a trend is cyclical of the corporate capex cycle or represents a permanent shifts. In case of the latter, we propose two recommendations that improve risk management of unsecured consumers and also incentivise banks to increase lending to industry that could kick off the required investment cycle.

I. INTRODUCTION

This essay examines the transformative impact of the Insolvency and Bankruptcy Code (IBC) on India's financial ecosystem, focusing on its implications for corporate credit, NPAs, and the broader credit landscape. Section 2 sets the stage with reference to Indian economic growth in the early 2000s, the increasing infrastructure investments, and potential hardships of financial distress and NPAs that eventually led to the IBC. Section 3 offers a general overview of the IBC, stressing that it is a revival tool rather than a tool for recovery. Section 4 demonstrates how the post-IBC rates of NPA recovery have improved while at the same time altering the behaviour banks to become more industry risk-averse lenders. Section 5 deals with the post-IBC credit market reshaping. This encompasses the emergence of NBFCs, change in lending patterns, and reallocation of credit into the personal loan segments. Section 6 talks about NBFC's increased exposure towards unsecured loans and potential systemic risk in consumer credit. Finally, Section 7 concludes with some policy recommendations that include tapping the data of UPI for credit assessment and introducing a securitization framework for industrial credit to maintain risk and growth in the credit market.

II. INDIA IN THE 2000S: PRE-IBC

During the early 2000s, India rapidly expanded, with GDP growth rates reaching 9-10% annually. Infrastructure investments surged, accounting for 38% of GDP by 2007-2008 as firms launched major projects, particularly in the power generation, steel and telecommunications sectors (Felman et al., 2017). However, the global financial crisis stopped this growth momentum and exposed corporations to significant financial risk. Unable to generate expected returns, many projects became unsustainable and companies struggled to service their debts. As a result, a substantial portion of these corporate loans turned into NPAs, severely impacting the balance sheets of banks and consequently the broader credit ecosystem.

Recognizing the economic slowdown and weakened credit flow, the government recognized the need for a solution to address the growing NPA crisis. Resolving these bad loans was essential to restore bank lending and support private sector investment. Adding to the problem, India lacked an efficient mechanism for companies to exit the market, which only worsened the financial strain on companies and banks alike. The legal landscape was also fragmented, with laws such as the Sick Industrial Companies Act, the SARFAESI Act, and others, none of which provided a cohesive, timely, or effective way to manage insolvency. The Twin Balance Sheet (TBS) Problem was one of the key drivers behind introducing the Insolvency and Bankruptcy Code (IBC) in India. This issue, which put banks and corporations under significant financial pressure, created a pressing need for a comprehensive framework to address and resolve financial distress.

III. WHAT IS IBC? NOT A RECOVERY MECHANISM, BUT A REVIVAL MECHANISM

In response to the TBS problem, the government introduced the Insolvency and Bankruptcy Code (IBC) in 2016, marking a significant shift in India's approach to financial distress and insolvency. The IBC was designed as a unified legal framework to address systemic issues in insolvency resolution, streamline distressed asset management, and ultimately restore confidence in India's credit market (Insolvency and Bankruptcy Regime in India - A Narrative, 2020).

A primary goal of the IBC was to move away from a debtor-friendly regime and establish a creditor-driven system. This new approach empowered creditors to play a central role in determining the course of action when a company was financially distressed, with decisions oriented toward asset recovery and financial stability. To achieve timely resolution, the IBC set a target of 180 days to resolve insolvency cases, with a possible extension of 90 days in exceptional cases, ensuring that distressed businesses are restructured or liquidated without undue delay.

Unlike the fragmented and lengthy recovery mechanisms previously available, the IBC provides a unified framework, helping banks recover funds more efficiently and improve the health of their balance sheets. This structural shift allowed the banking sector to confront the legacy of corporate defaults, which had eroded asset values, restricted lending capacity, and significantly increased recovery rates.

IV. IBC, NPAS & RISK AVERSION

The impact of the IBC on the recovery of NPA has been substantial, accounting for Rs.1,05,773 crore, or roughly 61%, of the total Rs.1,72,565 crore recovered across various mechanisms in 2019-20 (IBC emerges as major mode of NPA recovery in 2019-20, 2020). By March 2023, the Gross NPA ratio had reached a decade-low, largely due to lower slippages and improved asset recovery processes enabled by the IBC. Banks that had previously been weighed down by unresolved NPAs have seen marked improvements in their asset quality, allowing them to shift focus toward healthier lending practices and long-term profitability.

The introduction of the IBC has also increased recovery rates exceeding those achieved under prior mechanisms. By helping banks retrieve a greater portion of defaulted funds, the IBC has strengthened the bank balance sheets and allowed more effective reallocation of resources. Yet, the structural changes brought by the IBC have had mixed effects on the banking sector's approach to credit risk.

Recognizing the stringent recovery standards under the IBC, banks have adopted more conservative lending practices, increasing their scrutiny of borrowers' financial viability. This shift has directed banks' focus toward safer, lower-risk segments, such as retail lending, and away from large corporate projects that carry higher default risks. Empirical evidence supports this trend: studies indicate that after IBC's introduction, loan growth rates in high-risk industries saw a notable decline, signaling a shift in risk tolerance within banks. This conservative stance, while beneficial for asset quality, poses challenges for industries that depend on higher risk-taking by lenders to drive growth.

V. THE IMPACT OF IBC ON CREDIT

A note on the IL&FS crisis - in 2018, the financial system faced another blow when a large NBFC, the IL&FS (Infrastructure Leasing and Financial Services) defaulted on its debts. This sent shockwaves through the banking system as well as the debt markets – the two biggest funding sources for the NBFC sector. This was followed by other relatively low-impact shocks due to problems in NBFCs such as DHFL (Dewan Housing and Finance Limited) and Indiabulls Housing Finance, as well as in Yes Bank. This section discusses a change in how banks lend and the reemergence of NBFCs even after the IL&FS crisis. It may be difficult to conclude any net positive or negative benefits from such trends, but it's hard to dispute a reshaping of the credit market that's taking place. Three periods shall be referred to here, and a timeline of the same would benefit the subsequent analysis.

2015: AQR was mandated for banks
2016: First IBC regulations
2018: Second IBC regulations and IL&FS Crisis.

A. Loans and advances by NBFCs remain strong(Figure 1)

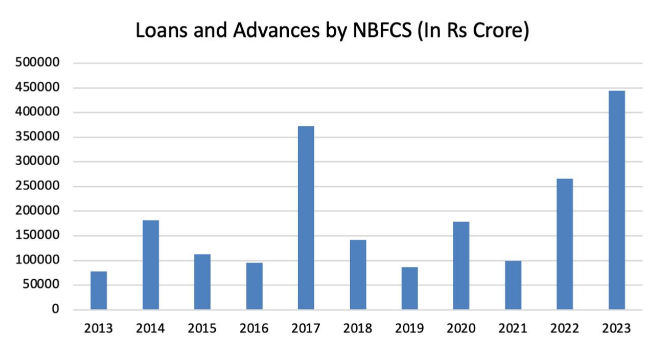

FIG. 1. Report on Trend and Progress of Banking in India: RBI

NBFCs suffered a volatile dispersion of credit up till 2016, and skyrocketed after 2016 potentially absorbing some of the credit demand shrugged off by banks after the implementation of IBCs and recognition of NPAs. However, the IL&FS crisis dampened NBFC lending until the post-COVID period, after which it rebounded rapidly.

B. Banks are reshaping how & where they're giving out loans (Figure 2)

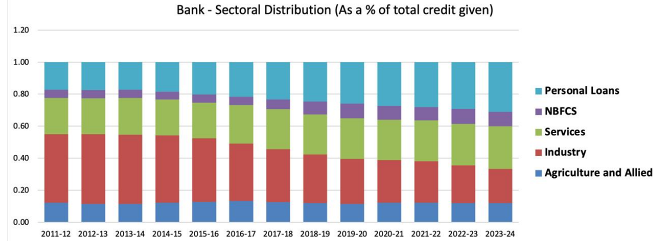

FIG. 2. RBI data

Until 2014-15, 42% of total bank credit was consistently directed towards industry. However, post-IBC saw this half within 8 years to 21%. But, where was this re-channelled? The share allocated towards personal loans almost doubled going from 17% in 2012 to 31% in 2023. This marks a key milestone in bank lending behaviour which is "consumerization" of bank credit. It also raises the question of credit towards industry- historically banks have been the chief supplier to this sector, but a decline could mean two things: (i) industries have started demanding less credit (ii) there are other sources of credit such as NBFCs, AIFs and bonds that sweep in to pick up the demand. We can say that banks have become more risk-averse to industry post the IBC crisis, but is their move towards personal loans a sound one? The risk-aversion from the banks' end towards industry-firms which predominantly borrowed from banks (and were small and risky) leads to limited supply of credit. This thwarts high-risk and high-growth sectors for major capex and also constrains MSMEs which have huge potential in a country such as India.

C. Flow of commercial credit

To better understand the rise of NBFCs, here are statistics on the growth rate of credit flow for commercial purposes across three groups - banks, NBFCs and others which include registered AIFI (All India Financial Institutions), Housing finance companies (HFCs), Commercial papers (CPs), and private placement of credit. We split into 3 periods- (i) introduction of AQR and IBC (ii) IL&FS crisis (iii) post crisis pick up.

Category	FY14-17	FY18-20	FY21-24
Bank Credit	-10%	-20%	38%
NBFCs	5%	-19%	65%
Others	20%	-5%	-7%

TABLE I. RBI: Handbook of Statistics on Economy of India

What we notice is that the flow of commercial credit post IBC and even extending to the 2018-20 period from banks was negative. NBFCs were relatively flat during IBC and AQR, but dipped post IL&FS into negative territory. All of this is in line with the events that happened and how these institutions would have reacted, but the outlier lies in the growth rate (CAGR) of credit flow during 2021-24. Although banks are quite strong, close to 40% driven by personal loans, NBFCs are growing at a phenomenally faster rate of around 65%.

D. Where are NBFCs lending?

One might assume that due to the risk aversion of banks towards industry, the vacuum created would be picked up by NBFCs but we see the opposite playing out when we understand where NBFCs themselves lend. Industry which was prominent post IBC contributing to 60% of lending of NBFCs has fallen to approximately 42% as of 2023. NBFCs are also "consumerizing" and moving away from industry.

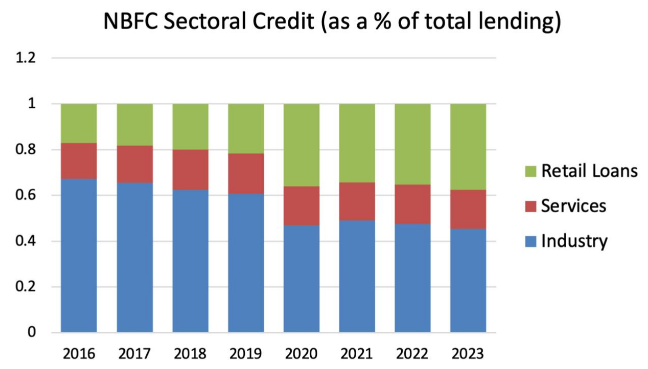

FIG. 3. RBI Data

A note on borrowing for industry- from the above data a question that arises is where are industries borrowing from, now that banks and NBFCs are moving away from lending to them. The only two options that remain are bonds and AIFs.

If we look at the bond market, the corporate bond market is heavily skewed towards higher rated papers. As per RBI, 80% of issuances in value terms in FY22 were rated AAA, and another 15% were rated AA. Our analysis also shows that while AAA rated companies may be able to source cheaper funds through the bonds market, this does not hold true for others. Essentially, lending towards industry has dampened and those that can avail leverage are characteristic of extremely well rated companies which are a small proportion of total companies.

VI. IBC & THE CONSUMERIZATION OF LOANS

As seen earlier, most commercial banks have become relatively risk-averse post the implementation of IBC. This has left most of the market untouched by the larger credit sources, leading to a huge gap in India's credit markets. As traditional credit opportunities dry up and only very safe bonds are available in the market, who addresses this large and burgeoning sector of MSME & consumer loans? NBFCs have come here and taken up a part of the market for loans to these individuals and institutions (Singh, 2023). While this may be seen as a good omen for credit growth in India, it comes attached with some problems. NBFCs have been allocating a larger part of their loan book as unsecured and quasi-secured loans, with unsecured loans hitting about 30% of AUM in FY23 (Gopakumar, 2023).

The RBI believes that such a high exposure to unsecured funding poses a major risk to these NBFCs and has even issued risk directives to quell their concerns (Unsecured loans, capital market funding can bring grief for NBFCs, 2024). There has been recent evidence that has even showed that these consumers have refinanced previous loans and have piled on more and more unsecured loans. This seems awfully reminiscent of the 2008 crisis, wherein homeowners ended up owning multiple loans but had no equity in them and the refinancing frenzy went on till home prices were rising. But as soon as the music stopped, and home prices came crashing down, delinquencies hit the roof and the default rates skyrocketed. With a similar situation brewing in the consumer loans market, NBFCs may soon face trouble.

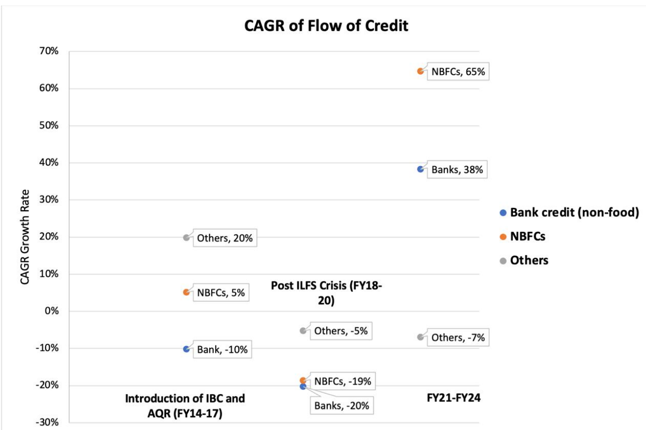

FIG. 4. Flow of Credit- Handbook of Stats on Indian Economy

In the corporate NPA crisis of 2015-19, the main credit institutions impacted were banks, whereas in the event of a consumer credit bust, NBFCs and fintech firms are likely to be affected as well. While the top NBFCs are now able to access the bond market and also get funding from banks, a contagion of consumer defaults can rapidly erode the credit rating of the NBFCs that have lent to the defaulting consumers. As a result, NBFCs can rapidly lose their access to funds. Since banks have an exposure to NBFCs and retail customers, such a contagion will also impact them. Depending on the severity of the defaults, this can soon morph into a systemic crisis (Sengupta and Vardhan, 2024).

VII. CONCLUSION AND POLICY RECOMMENDATION

The data along with the analysis above suggests certain trends:

1. Commercial borrowers who previously could only access credit via banks (small and risky firms) are seeing banks turning averse to such lending.

2. Much of the rolled-out credit is heading towards consumers, from banks as well as NBFCs, and the fastest growing segment is unfortunately unsecured loans. Any crisis will not only see banks suffer but NBFCs as well.

3. There is a vacuum from the drawback of industry credit by banks that is partially addressed by NBFCs- and this is no longer under the jurisdiction of IBC which poses a significant risk.

The introduction of IBC which is often hailed as a revolution in the banking system unfortunately led to a chain of events with consequences such as risk-aversion to industry, a new unregulated play under NBFCs and consumerisation of credit. The next half-decade will be crucial in determining whether such trends are cyclical of commercial capex cycles or a permanent shift in lending behaviour. Addressing the next steps, our policy recommendation hinges on 2 key aspects; reducing the riskiness in the credit market and driving credit growth towards industry for larger economic growth.

A. Leveraging UPI Data

One such policy that could help strengthen the credit market is the introduction of the Unified Lending Interface (ULI). ULI will allow the seamless provision of credit to different industries and sectors of society, primarily focusing on farmers, MSMEs, and those that are credit constrained. The purpose of ULI is to integrate digital records of individuals and businesses to make it easier for the credit appraisal process and allow banks and financial institutions to lend faster and at better terms to borrowers.

We propose an addition to the credit evaluation mechanism- UPI records. With the uptick in UPI usage across SMEs, spending behaviour can easily be assessed by looking at UPI data. A larger weight must be assigned to this while looking at credit worthiness. Such elaborate ledgers can use machine learning algorithms for SMEs as well as customers. By providing this digital ledger of credits and debits, UPI creates a strong foundation to expand ULI's role in the Indian credit market, making credit both more accessible and secure.

B. Introducing a Market for Credit Securities

To incentivize banks to increase lending to industries while managing risks, we propose the Industrial Credit Securitization Framework (ICSF). Under this model, banks will originate industrial loans and package them into securities (such as a Specialised Purpose Vehicle-SPV), which can be sold to institutional investors, sharing the risk of potential NPAs. To maintain accountability, banks must retain at least 50% ownership of the SPV on their balance sheets. A new regulatory body, the

Industrial Credit Securitization Agency (ICSA), will act as a neutral intermediary, anonymizing data about these securities before forwarding it to credit rating agencies to ensure unbiased ratings. The framework will enable the creation of a robust secondary market for industrial credit securities, fostering liquidity and attracting investments. An important factor is maintaining anonymity of the bank selling such a security to maintain ethical standards by rating agencies. Ratings agencies will only have access to data pertaining to evaluating credit scores, and publish reports that are associated with an anonymous bank code that's updated regularly.

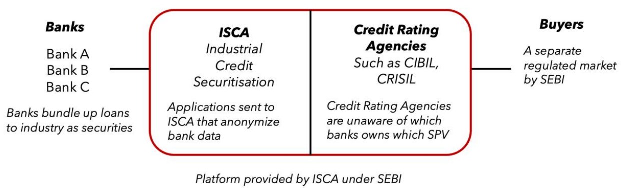

FIG. 5. Structure of ICSA

The above figure shows the structure of ICSA and explains the role of credit agencies, ICSA, banks and buyers of such instruments.

By securitizing loans, banks can diversify their risk exposure while retaining enough to avoid toxic lending. ICSA will monitor compliance, ensure transparency through audits, and oversee fair practices. We also condemn such a practice being extended towards consumer loans that may have a characteristic of unproductive uses for credit, unlike loans to SMEs and industry.

This system would draw lessons from the Global Financial Crisis but would allow the implementation of a similar system to spur economic growth. The Originate-to-Distribute Model would be a key feature of this policy and would require the support of SEBI for its smooth implementation. For a developing country like India, such an intervention that drives credit growth from the supply side of the economy rather than entirely from the demand side would ensure its journey towards a developed economy.

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