

Press Release

An IIMA Misra Centre for FME study on Insolvency Regimes and Firms’ Default Risk Under Economic Uncertainty and Shocks**[[1]](#endnote-1)** (forthcoming in *Economic Modelling* journal)

**June 22, 2020 | Ahmedabad:**

**SUMMARY:**

One of the arguments often advanced for implementing a stronger insolvency and bankruptcy framework is that it enhances credit discipline among firms. Using a large cross-country firm-level dataset, the study empirically test’s whether a stronger insolvency regime reduces firms’ likelihood of defaulting on their debt. In particular, it examines whether it reduces default risk during increased economic uncertainty and various external shocks. The results confirm that a stronger insolvency regime moderates the adverse effects of economic shocks on firms’ default risk. The effects are more pronounced for firms in the top half of the size distribution.

The study also explores channels through which improved creditor rights influence firms’ default risk, including dependence on external finance, corporate leverage, and managerial ethics. The main results are robust to an alternative measure of default risk, inclusion of currency and sovereign debt crisis episodes, and alternative estimations.

The full report is available along with other working papers on Misra Centre on Financial Markets and Economy (MCFME) page: <https://www.iima.ac.in/web/areas-and-centres/research-centres/misra-centre-for-financial-markets-and-economy/research-and-publications>

**KEY INSIGHTS/FINDINGS FROM THE SURVEY:**

Using data from 60 countries for about 13,000 firms, a study by Prof. Balagopal Gopalakrishnan (IIM Kozhikode) and Prof. Sanket Mohapatra (IIM Ahmedabad) finds that a stronger insolvency and bankruptcy framework is likely to enhance credit discipline among firms and reduce their risk of future debt default. A stronger insolvency regime is usually associated with reduction in the time and cost of proceedings and involves a higher recovery rate in the event of bankruptcy. In a stronger insolvency framework, where the promoters have a greater risk of losing control of the firm, the study finds that corporate managers are likely to be more conservative in their investment and financing decisions, and consequently, can reduce the risk of a debt default.

The study also finds that in countries with stronger insolvency regimes, the adverse effects of policy uncertainty and economic crisis (such as the COVID-19 pandemic) is moderated, as firms would have made more prudent decisions ex-ante to lower their risk of debt distress in such a scenario.

India has implemented significant bankruptcy reforms with introduction of the Insolvency and

Bankruptcy Code (IBC) in 2016. As a result of these reforms, India’s position in the World Bank’s Resolving Insolvency ranking has increased sharply in recent years, from 132 in 2016, the year in which IBC was introduced, to 52 in the 2020 ranking.

Although the IBC is suspended currently due to the COVID-19 pandemic-induced deep economic crisis, the study suggests that the insolvency reforms in India will have important implications for the corporate sector in a post-COVID scenario. While the suspension of IBC may be warranted in the current economic climate, a possible downside of suspending it for an extended period is that it could encourage riskier behaviour among firms.

1. *The report is by Prof. Balagopal Gopalakrishnan of IIM Kozhikode and Prof. Sanket Mohapatra of IIM Ahmedabad* [↑](#endnote-ref-1)