

Resolvability Index: What it is and why it is useful.

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The Perspective

Death is inevitable to life. Nevertheless, it is possible to mitigate death to a great extent, provided one consciously avoids all the causal risks such as tobacco or drugs. Likewise, a company can face several risks to its life. In order to mitigate such risks, the promoters and managers have to actively anticipate such risks and work against it. Business stress is prevalent, subject to the market conditions. The company has to accordingly develop a rescue plan at the earliest indication of stress.

The Insolvency & Bankruptcy Code, 2016 envisages the corporate insolvency resolution process (CIRP) for rescuing companies from the stress. Since, CIRP rescues a company through a resolution plan, the term 'resolvable' is used in place of 'rescuable'. India had a tryst with recovery laws which changed with the advent of the IBC. With the inception of IBC, the creditors shifted their focus from recovery to resolution in case of default. The probability of resolution, which usually exceeds the probability of recovery, coupled with higher realisations and revival of the company, makes CIRP an attractive option for creditors. However, this is subject to the condition that the company is capably 'resolvable'. In case of low resolvability, the company may yield in natural death of liquidation and the creditors might recover only peanuts. Ideally, conscious efforts to be resolvable will make the company resilient against stress. Even if the company goes into stress, its resolvability will make it an attractive feature for the takers. Hence, the resolvability health of a company is a win-win for both the company and creditors.

The authors of this paper attempt to develop an index to measure the degree of resolvability of a company. The resolvability index may carry a negligible cost associated with the development and periodical calculation, but it is comparatively insignificant as opposed to rescuing the life of a company. A legal framework must also be developed which mandates maintaining a minimum threshold of resolvability by the company. The index will aid in prevention of death of viable companies which in turn improves the Indian credit culture.

Concept of Resolvability

Resolvability of a business is the ability of a business to remain viable and financially solvent in the face of economic and market forces. This includes the ability of a business to absorb the impacts of market volatility, cultural shifts, and other changes that occur in the business environment. It also includes having enough funds available to cover operational costs and debt obligations while still being profitable.

In order to assess a business's resolvability, it is important to consider its financial health. This includes analysing its balance sheet, income statement, and cash flow statement to assess its current financial position and performance. It is also important to consider the business's debt-to-equity ratio, liquidity ratio, and other ratios to see how efficiently the business is operating. The other important factor to consider is the business's market position.

Apart from the financial angle, it is also essential to understand the legal framework within which the business operates. This will involve an analysis of the business's structure, as well as any applicable regulations and laws. Furthermore, it is important to study the management of the business. This includes the ability of the management to make sound decisions and the management style of the business. It is also important to understand the relationships between the stakeholders in the business and how they interact with each other.

Finally, it is important to consider the market conditions and the competitive landscape within which the business operates. This includes understanding the business's competitors, the potential markets and customers, and the potential risks associated with the business. All of these factors need to be taken into account in order to properly assess the resolvability of a business. By understanding these factors, one can assess the likelihood of the business's success and determine the best course of action to ensure the business's solvency.

What is a resolvability index?

Insolvency is a situation where an individual or entity is unable to pay their debts. In this situation, the resolvability index, an economic metric, can be used to assess the potential for the debtor to successfully negotiate a restructuring of their debt. The index is based on several factors, including the amount of debt owed, the size of the debtor's assets and liabilities, the debtor's ability to raise capital, and the type of debt owed. Other factors such as the debtor's credit history and the current economic climate may also be taken into account. The higher the index, the higher the likelihood that the debtor will be able to successfully resolve their situation and move forward.

Objectives of Resolvability Index

The Resolvability Index is a tool used to measure the success of insolvency and bankruptcy proceedings under the Insolvency and Bankruptcy Code of India (IBC). The index was conceptualised as part of the government's concerted efforts to improve the efficiency and effectiveness of the IBC's insolvency resolution process. The Resolvability Index takes into account various parameters that measure the success of insolvency proceedings, such as the number of cases resolved, the return to creditors, and the amount of losses the creditors have to bear. The index is calculated by multiplying the value of the average return to creditors by the number of cases resolved and then dividing the total by the total value of the losses incurred.

The Resolvability Index should be designed to be an objective measure of the efficiency of the insolvency resolution process. By tracking the progress of insolvency proceedings over time, the index can provide valuable insights into the effectiveness of the IBC in delivering timely resolution of insolvency cases. The index can also be used by the Insolvency and Bankruptcy Board of India (IBBI) to assess the performance of insolvency professionals. By providing an objective measure of the success of insolvency proceedings, the Resolvability Index can help to improve the overall efficiency of the IBC and the insolvency resolution process. It can also help to ensure that creditors receive the best possible return on their investments, while minimising the losses they suffer.

Developing Resolvability Index

In order to arrive at the "Resolvability Index", it is pertinent to analyse the company from the financial, legal, and other relevant perspectives. Therefore, one must look at both internal and external factors.

Internal Factors

- 1. Industry risk:** The analysis of industry risk enhances the comparability and transparency of ratings among sectors by comparing and scoring inter-industry risk. This risk also depends on Competitive risk and growth environment (barriers to entry; level and trend of industry profit margins; risk of secular change and substitution; and growth trends.)
- 2. Cash Flow/ Leverage:** This leg analyses the funds from operations to debt and debt to EBITDA. These two payback ratios are used as the initial ratios to determine the relative ranking of the financial risk of companies. This preliminary assessment may then be adjusted through additional ratio analysis.

3. **Capital structure:** The assessment of a company's capital structure captures risks that may not arise in the standard analysis of cash flow adequacy and leverage.
4. **Financial Policy:** The cash flow/leverage score, in particular, will typically factor in operating and cash flows metrics observed during the past two years and their anticipated trends for the current year and the following two years based on operating assumptions and predictable financial policy elements, such as ordinary dividend payments or recurring acquisition spending.
5. **Liquidity:** Liquidity is an important component of credit risk across the entire rating spectrum. Unlike most other rating factors within an issuer's risk profile, a lack of liquidity could precipitate the default of an otherwise healthy entity. Liquidity is an independent characteristic of a company, measured on an absolute basis. The quantitative analysis of liquidity focuses on the monetary flows--the sources and uses of cash--that are the key indicators of a company's liquidity cushion.
6. **Management and governance:** The evaluation of management and governance encompasses the broad range of oversight and direction conducted by an enterprise's owners, board representatives, executives, and functional managers. Their strategic competence, operational effectiveness, and ability to manage risks shape an enterprise's competitiveness in the marketplace and credit profile.
7. **Valuation:** Firms should have valuation capabilities that would enable an independent valuer to carry out sufficiently timely and robust valuations to support effective resolution. Firms have made substantial progress with respect to their valuation capabilities for resolution. Valuations in a resolution require a large amount of analysis to be undertaken in a relatively short timeframe. Firms therefore need to ensure that relevant data and information supporting such valuations are robust and could be made readily available.

Restructuring a firm following resolution is an inherently complex task and will result in uncomfortable decisions, potentially including significant changes to its business model and structure in order to address the causes of failure. Companies need to understand the different set of challenges and potential context-specific implications of a resolution, including for the identification of restructuring options to support the restoration of a viable business model that is sustainable in the long-term. Companies should ensure that these capabilities are able to handle

the unique demands of resolution, considering how different stakeholders across the world can be best served, and how communications plans across other barriers should be linked.

External Factors:

Pestle Analysis is a concept developed by Francis Aguilar a Harvard professor in the year 1967. At the nascent stage of developing, it was called PEST analysis, and in very recent times Legal and Environment factors was included and is called as PESTLE analysis. It is a strategic tool which is used to assess markets for a particular product or a business at a given timeframe. Most companies employ this tool to track environments they are operating on or planning to operate. It is also one the most essential framework that helps businesses and organizations to understand the various external factors that can impact their operations and performance.

To formulate a “Resolvability Index” of a company it is important to consider and evaluate both the internal and external factors associated with the company. This tool serves in evaluation of the external factors associated with the product or company as a whole. The factors employed in the tool are explained hereby:

1.Political Factors: Political factors address various laws including political stability, tariffs, taxation, trade disputes, fiscal policy, trade barriers and potential corruption which are directly proportional to the changes which can be anticipated to be brought in the near future by the government. This indicates significant impact on company’s operations and profitability.

2.Economic Factors: Economic factors include the overall stage of the business cycle, potential for economic growth or contraction, exchange rates, interest rates, inflation, labour costs and labour supply, unemployment rate, impact of new technology on the economy, impact of globalization on the economy, levels of disposable income and income distribution. It helps in the indication of consumer spending and purchasing power in the overall business environment.

3.Social Factors: Social factors include the demographic characteristics and attitudes of the population towards age and growth of population, health consciousness, cultural barriers, happiness index and trending lifestyles. This determines the consumer behaviour and preferences.

4.Technological Factors: Technological factors include level of innovation, emerging technologies, cyber security, internet availability and speed, the rate of technological change, and the impact of technology on how people live and work such as an increase in remote working, reduced

communication costs, rising demand for new technology product. This determination helps in how the company operates and the product and services it offers.

5.Legal Factors: Legal factors includes the laws and legal framework that affect the organization's environment such as health & safety laws, employment law, consumer law, discrimination laws and copyright protection.

6.Environmental Factors: Environmental factors are any of the trends or impacts of the weather, environmental policies, natural disaster to climate change, pollution and sustainability from environmental regulations to rising demand for eco-friendly "green" products. By determining this we can understand the reputation and brand image of the company.

Altman Z-Score

In the late 1960s a financial metric was developed by Professor Edward Altman, which is now known as Altman Z-score. It is very nuisance and advanced formula that combines five financial ratios to provide an overall assessment of company's financial health and the likelihood of it experiencing financial distress or bankruptcy.

$$Z\text{-score} = 1.2A + 1.4B + 3.3C + 0.6D + 1.0E$$

Where:

A= working capital / total assets

B= retained earnings / total assets

C= earnings before interest and taxes (EBIT) / total assets

D= market value of equity / total liabilities

E= sales / total assets

The relevance of Z-score can be witnessed at situations of in Insolvency and Bankruptcy as it helps in anticipating the financial position and likelihood of a company experiencing financial distress or bankruptcy. The Z-score represents a numerical representation of a company's financial health, and

a low Z-score which is below 1.88 indicates a high risk of bankruptcy. Therefore, the Altman Z-score helps to identify companies that may be at risk of insolvency and bankruptcy.

In the Corporate Insolvency Resolution process (CIRP) before sending the expression of interest (EOI), the Altman Z-score can be used by creditors and investors to evaluate the creditworthiness of a company and make informed decisions about lending, investing, or purchasing the company or submitting a resolution plan. Using this score can be a precautionary step for the creditors to reconsider lending money to a company or for investors in submitting the resolution plan if there is an indication of low Z-score.

In terms of the promotor, the Altman Z-score can be used by the management of the company's management to assess their company's financial health and identify areas that need improvement. By monitoring the Z-score of a company periodically the company can have a check on their financial health and take proactive steps to avoid bankruptcy. Ultimately, this score helps promoters and investors to evaluate a company's financial health and make informed decisions.

International Experience - United Kingdom

The UK's resolution framework is a core part of the response to the global financial crisis of 2007–08 and the approach to overcome the problem of firms being 'too big to fail'. The resolution regime ensures major firms can remain open and operating with shareholders and investors bearing losses and the costs of recapitalisation. This helps to preserve financial stability as the critical functions of the firm can continue while an orderly restructuring takes place. Resolution therefore reduces risks to depositors, the financial system, and the need for public funds that could arise due to the failure of a firm.

Resolution imposes losses on failed banks' shareholders and investors, not taxpayers. It ensures larger firms' services can continue to operate for a sufficient period, allowing authorities or new management to restructure them or wind them down. The Resolvability Assessment Framework (RAF) builds on the work done since the financial crisis and sets out the next step in implementing the resolution regime: ensuring that firms are, and can demonstrate that they are, resolvable. This will require firms to have the capabilities necessary to support their resolution. To this end, it

clarifies firms' responsibilities concerning resolution and sets out how the Bank and Prudential Regulation Authority (PRA) will increase transparency and accountability.

The RAF draws together Bank and PRA policies into three outcomes which firms need to be able to achieve so they are prepared for a resolution. The three outcomes' firms must achieve are:

- A. having adequate financial resources in the context of resolution;
- B. being able to continue to do business through resolution and restructuring; and
- C. co-ordinating and communicating effectively internally and with the authorities and markets so that resolution and subsequent restructuring are orderly.

1. Adequate Financial Resources: To meet the Adequate Financial Resources outcome, firms need to ensure that they have resolution-ready financial resources available to absorb losses and recapitalise them without exposing public funds to loss. Firms must also have access to sufficient liquid resources to meet their financial obligations in resolution. Both are necessary to keep the firm operating. Firms need to:

- 1. meet the 'minimum requirement for own funds and eligible liabilities' (MREL) and to ensure that these resources are appropriately distributed across their business;
- 2. be able to support a timely assessment of their capital positions and recapitalisation needs (Valuations); and
- 3. be able to analyse and mobilise liquidity in resolution (Funding in Resolution).

2. Resolution and Restructuring: To meet the Continuity and Restructuring outcome, firms need to ensure that they can continue activities while the authorities execute a resolution. This includes ensuring that the resolution does not result in the firm's financial and operational contracts being materially disrupted or terminated and that direct or indirect access to services delivered using Financial Market Infrastructure is maintained.

Firms should be able to plan and execute restructuring effectively and on a timely basis in the event of resolution. Relatively more work is required across the sector on Restructuring Planning than other barriers, and this will need to be a key area of focus for firms. Firms have built upon their existing recovery planning arrangements to put in place the capabilities needed to deliver a business reorganisation plan which, once implemented, would aim to address the causes of failure and return the firm to a viable business model.

Firms also need to be able to plan so that they can execute post-resolution restructuring effectively (Restructuring Planning). Firms should be capable of continuing to operate, serve their clients and customers, and return to long-term viability as a restructured business.

Restructuring a firm following resolution is an inherently complex task and will result in uncomfortable decisions, potentially including significant changes to its business model and structure in order to address the causes of failure. Firms need to understand the different set of challenges and potential context-specific implications of a resolution, including for the identification of restructuring options to support the restoration of a viable business model that is sustainable in the long-term.

3. **Co-ordination and Communication** : To meet the co-ordination and communication outcome, firms need to have capabilities, resources, and arrangements in place to meet the objectives. Firms should be able – during the execution of a resolution – to ensure that their key roles are suitably staffed and incentivised, that their governance arrangements provide effective oversight and timely decision-making, and that they deliver timely and effective communications to staff, authorities, customers and other external stakeholders.

Firms should ensure that these capabilities are able to handle the unique demands of resolution, considering how different stakeholders across the world can be best served, and how communications plans across other barriers should be linked.

Some firms have further enhancements to make in order to identify more clearly their internal triggers to start pre-resolution contingency planning. Some firms also need to ensure that they have a flexible governance framework for how they would interact with a Bail-in- Administrator (BIA) appointed by the Bank. In particular, we expect firms to consider and plan for various roles that the BIA could potentially perform in a resolution, as well as to ensure suitable on-boarding and support is provided to the BIA to ensure an orderly resolution.

Conclusion

By considering all these factors, a company can develop a “Resolvability Index” which is a measurement of its ability to respond and adapt to changes in the external environment. This can help the company to anticipate and mitigate risks, as well as identify new opportunities for growth

and expansion. Overall, PESTLE analysis is a valuable tool for business and organizations of all sizes and industries to better understand the external factors that can impact their operations and performance.

The resolvability Assessment framework has evolved in the banks of the UK for the resolution and restructuring of the firms. Under this framework, each firm's structure and business model is taken into account as well as the preferred resolution strategy set for each firm, by assessing the firms' arrangements and capabilities against the Bank's resolution policy expectations to identify any gaps or weaknesses in firms' ability to achieve the three outcomes in the event of their resolution. Under the current Indian Regime of the IBC, there is no such resolvability Index framework to assess the resolvability of the distressed company. The lawmakers must build a index by considering both the Internal and External Factors to resolve the distressed companies in the time bound manner. This will help the Insolvency Professional and the Resolution Applicant to resolve the company earliest.