Do Creditor Rights Reduce Tunneling? Evidence From India's Bankruptcy Law Reforms

Executive Summary

This paper investigates whether improved creditor rights reduce "tunneling". Tunneling is a practice where the company managers misuse funds within a group of companies for personal or strategic gain. Tunneling often involves giving out cheap loans, buying overvalued assets, or paying excessive dividends to related-party firms, which might disproportionately harm minority shareholders, creditors, and the broader economy. This is even more problematic when firms are already in a financially weak position and are kept alive by banks through the process of "evergreening." Evergreening is the act of renewing loans or extending new loans to help a borrower avoid default without addressing their inability to repay.

In particular, the paper evaluates the impact of a creditor rights improvement legislation -- the Insolvency and Bankruptcy Code (IBC), which India adopted in 2016. This reform marked a major shift in the country's approach to corporate debt and insolvency and replaced a more than a century-old bankruptcy regime that was slow and inefficient. The IBC law contains provisions that both encourage banks and creditors to initiate bankruptcy against insolvent firms, and for firms to willingly repay creditors to avoid loss of control. On the creditors' side, higher and quicker expected recoveries would enable them to reduce the impact of recognizing bad loans on the provisioning requirements. The IBC also streamlined the bankruptcy process by establishing specialised courts called the National Company Law Tribunals (NCLTs) to effectively handle insolvency cases. On the firms' side, the fact that the control of the company shifted to a professional resolution manager when the firm defaulted disincentivizes firms' managers to continue evergreening. These reforms also improved resource allocation as they were aimed at stopping the strategic misuse of funds and increasing the recovery of bad loans.

We use data on related party transactions (RPTs) from 2014 to 2019 and focus on companies that were financially distressed before the reform. We classify a subset of these firms – those that managed to survive using cheap bank loans – as being more affected by IBC. These 'treated' firms were more likely to be tunneling, and they are compared with other financially distressed firms before the reform period that managed without these loans. A study that compares our treated firms with the control before and after the IBC reform cannot negate the possibility that the other nationwide policies implemented during the same time as IBC drive our results. To causally identify IBC as the main driver of the effects we observe, we bring in a "third difference" – the efficiency of Debt Recovery Tribunals before IBC. Our hypothesis is that IBC should have a greater effect wherever DRT courts were less efficient. In sum, the three differences that pin down the causal effects are: i. Changes in financial transactions before and after the IBC, ii. Differences between treated and control firms, and iii. The differences across states with varying levels of court efficiency (less efficient states saw a bigger improvement under IBC).

The key finding of this paper is that tunneling fell sharply after the IBC implementation. Financial transactions with related parties (like loans and asset purchases) drop by over 90% in treated firms in states with less efficient DRTs. Among the components of financial RPTs, the biggest drop was in related-party loans, which previous research has pointed out to be an important tool to conduct tunneling. Operational transactions (like buying goods/services from related parties) did not change much after the implementation, which might indicate the fact that creditors could more easily monitor financial dealings than operational dealings.

The results are notable in a context where much of the popular debate around IBC and its effectiveness centers around assessments of the resolution process and the ex-post impact on firms that were revived under the IBC. In contrast, this paper shows that IBC has ex-ante effects where firms' managers change behaviour even without entering the bankruptcy process.

Other results suggest that after the policy implementation, firms voluntarily reduce borrowing. Firms also rely on internal funds by cutting back on dividends and related-party payments to reduce debt. These results are strictly related to improved financial discipline and not performance, as there was no clear improvement in firm profitability, sales, or investment post-reform. This empirically establishes that the observed effects are specifically linked to the rollout of the IBC. We validate this claim by testing on unrelated firms and using unrelated court efficiency measures (like civil court congestion), where the effect disappears, confirming the robustness of the results.

The study suggests that empowering creditors through strong legal frameworks can reduce the misuse of company funds and discourage bad financial behavior. This is important in countries where weak enforcement has allowed businesses to escape accountability. The IBC's threat of loss of control is an effective deterrent. Managers, fearing punishment or legal action, became more cautious and repaid loans using the firm's money instead of propping up through funds from other firms in the corporate group. Importantly, this paper shows that improvements in creditor rights can induce behavioural changes among firms' managers even before the firms go to bankruptcy.