

WIRC of ICAI

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Packaged Insolvency for MSME

By

Rajendra M. Ganatra

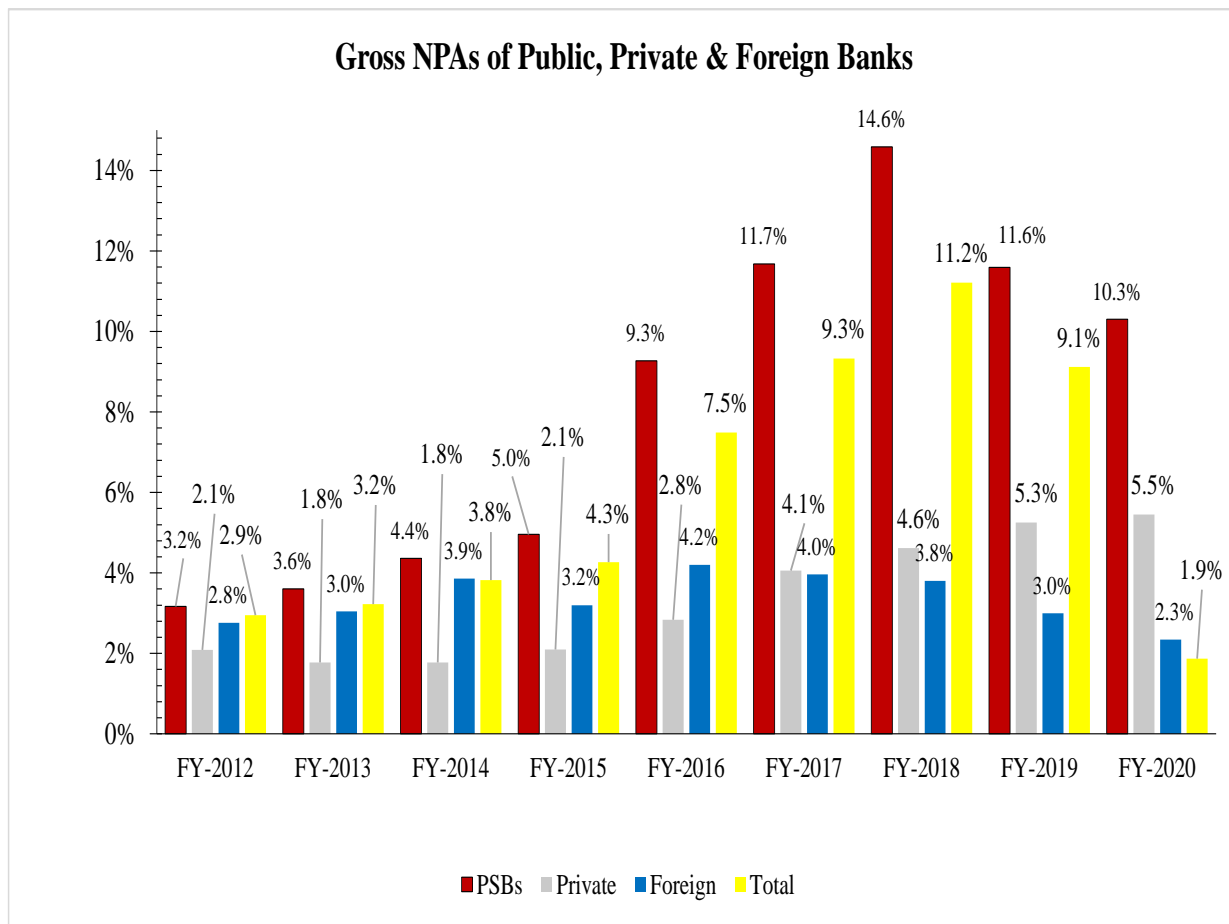
BE(Mech. Engg), CAIIB, CFA (India), Ph.D.

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Introductory remarks

- NPA levels, recovery, and what to accept while resolving insolvency



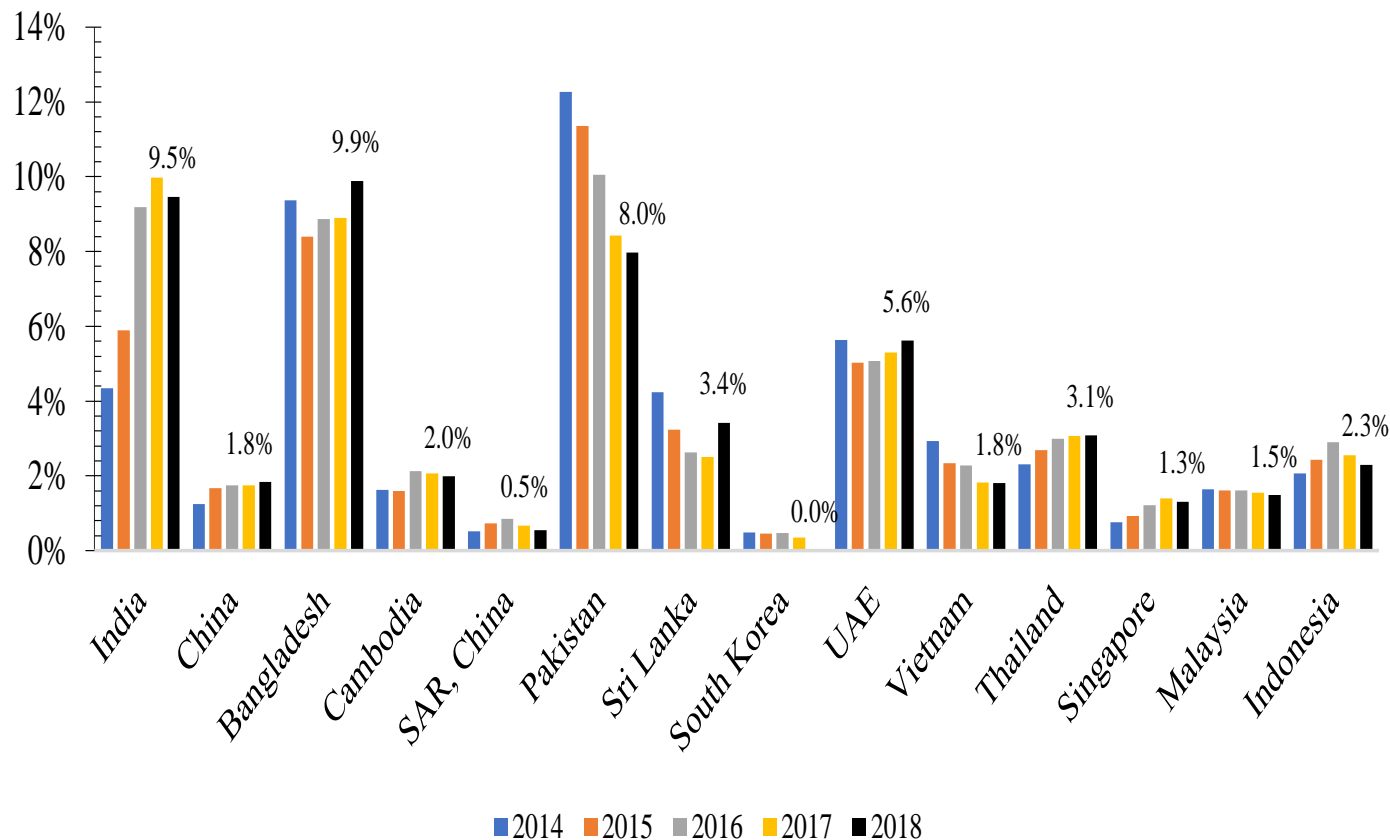
Points for discussion

- What is the reason for spurt in NPA levels from FY-2016 onwards?
- Are the NPA levels acceptable or too high?
- Does the ownership pattern of the banks impact NPAs?
- Why are we looking at these figures?
 - For (b) above, let's see peer comparison

Introductory remarks

Indian banks' NPAs compared with those of Asian peers

India Bank NPAs compared with Asian Peers

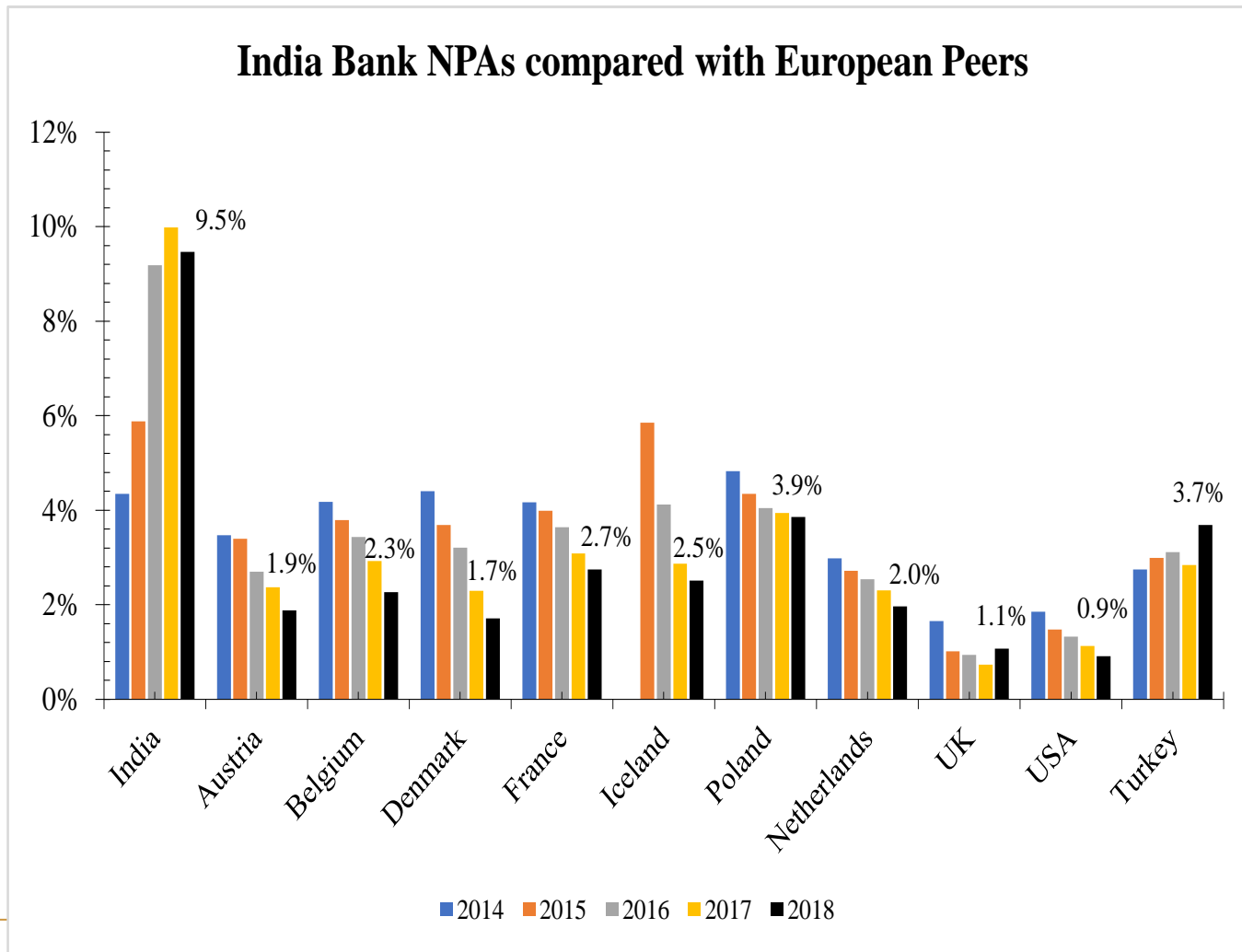


Points for discussion

- Where do we stand in comparison?
- What seems to be acceptable NPA level comparatively?

Introductory remarks

Indian banks' NPAs compared with those of European / US peers

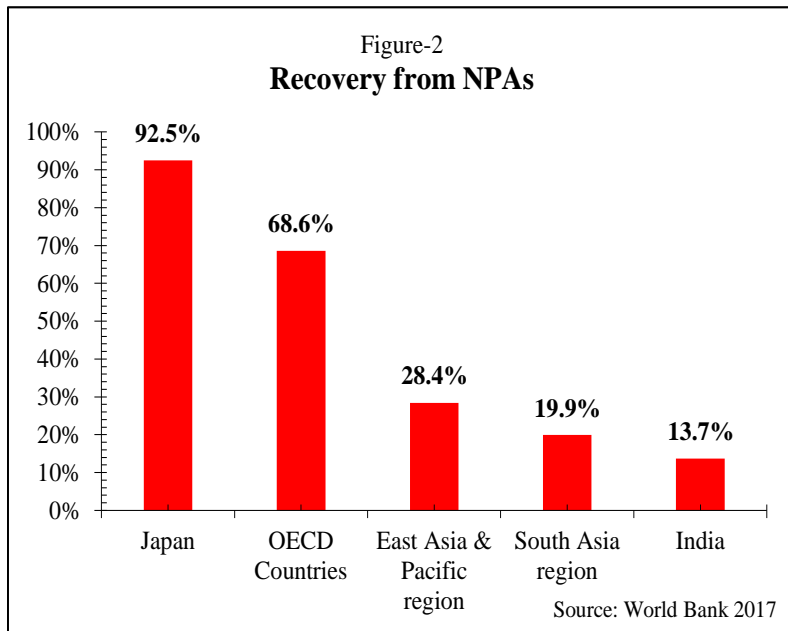


Points for discussion

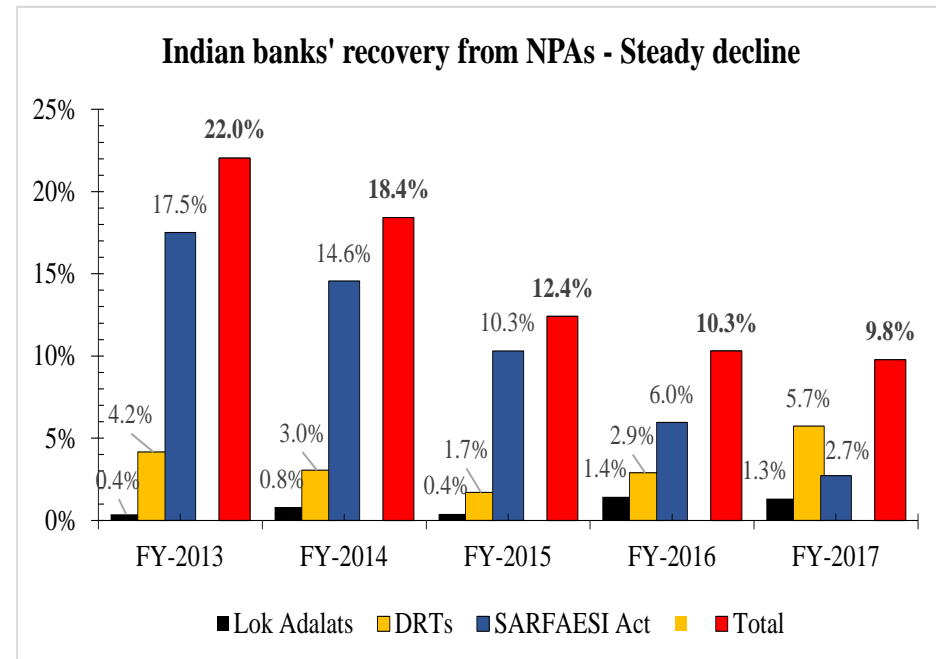
- Where do we stand in comparison?
- Can we now arrive at acceptable NPA level comparatively?
- What are the causes of such high NPAs of PSBs?
- Does this have implication for insolvency resolution?

Recoveries from NPAs in India

World Bank data



RBI data



Points for discussion

- Are all the companies subjected to CIRP NPAs?
- Can CIRP under IBC deliver higher value / credit recovery?
- Why have recent controversies cropped up?
- Let's understand credit recovery legislations vis-à-vis IBC, and pros and cons

IBC structure

Divided in to V Parts containing 261 Sections and 12 Schedules

<p>Part I: Preliminary</p> <ul style="list-style-type: none"> • Provides for Short title, extent, commencement, application of the Code and Definitions of terms used in the entire Code 	<p>Part II: Insolvency Resolution and Liquidation for Corporate Persons</p> <ul style="list-style-type: none"> • Divided into 7 Chapters • Covers Corporate Insolvency Resolution (CIR) Process, Liquidation Process, Fast Track CIR, Voluntary Liquidation, AA, and Offences and Penalties - 	<p>Part III: Insolvency Resolution and Liquidation for Individuals and Partnership Firms</p> <ul style="list-style-type: none"> • This Part too, is divided into 7 Chapters • Covers Fresh Start Process, Insolvency Resolution, Bankruptcy Order, Administration and distribution of the bankruptcy estate, AA, and Offences and Penalties 	<p>Part IV: Regulation of Insolvency Professionals, Agencies and Information Utilities</p> <ul style="list-style-type: none"> • 7 Chapters • Deals with the institutional framework under the Code – calls for the establishment of the Board, discusses its powers and functions • Also covers IPs, IP Agencies, and Information Utilities • Inspection and Investigation of IP Agency has also been dealt with 	<p>Part V: Miscellaneous</p> <ul style="list-style-type: none"> • Calls for repeal of certain enactments and savings • Requires amendments in certain enactments • Contains transitional provisions • Empowers the Central Governments to make Rules, and empowers the Board to make Regulations.
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Consistency between resolution under IBC and credit recovery

- Equity value = $\text{Max}(V - D, 0)$

Where,

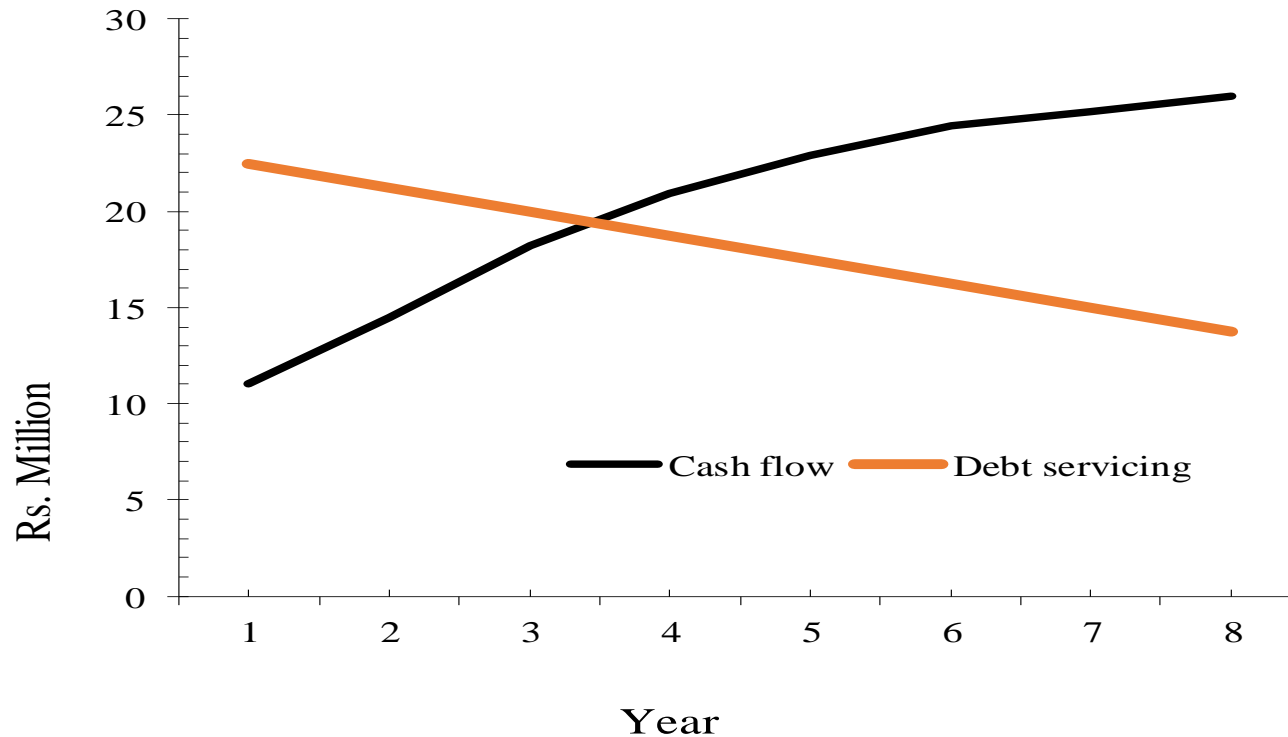
- V = Enterprise value which is the present value of the company's free cash flow to firm during its economic life (FCFF)
 - D = Debt
 - $V - D$ is residual after debt serviced
 - While the corporate debtor seeks to maximise " $V - D$ " the creditor seeks to maximise " D "
 - The successful resolution plan is one where both the creditors and corporate debtors converge on certain value of " D ".
 - Such convergence entails maximisation of " V ".
 - This clearly shows that maximised credit recovery is embedded in IBC's accent on resolution and value maximisation.
-
- How to realise this? Through transparent competitive bidding sans gaming

Types of insolvencies and remedies

Moderate cash flow mismatch

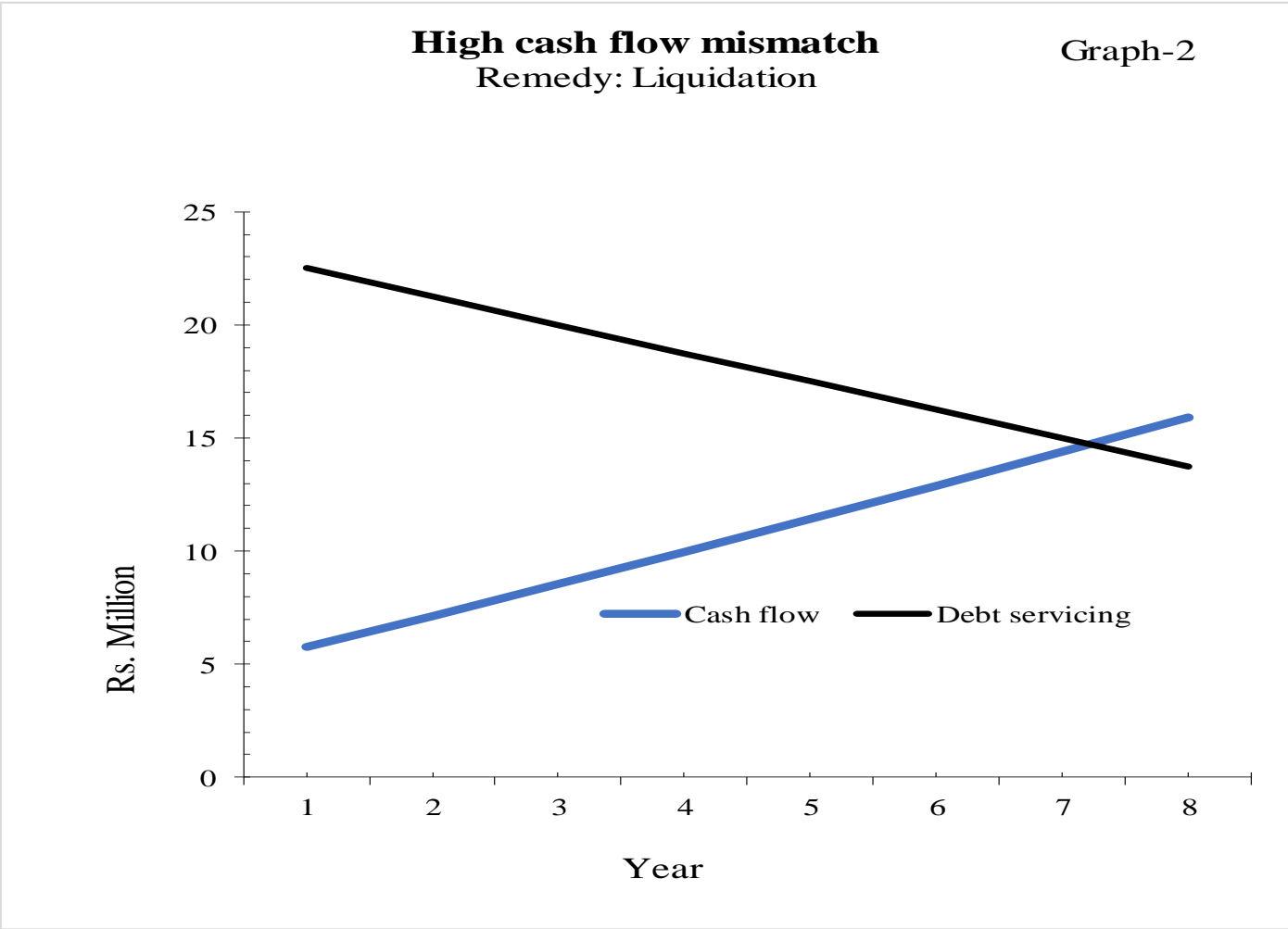
Remedy: Restructuring

Graph-1



- Cash flow insolvency
- Remedy: Restructuring

Types of insolvency and remedies



- Balance sheet insolvency
- Remedy: Liquidation

MSME Definition

Micro	Small	Medium
Investment < Rs. 1 crore	Investment < Rs. 10 crore	Investment < Rs. 50 crore
Turnover < Rs. 5 crore	Turnover < Rs. 50 crore	Turnover < Rs. 250 crore

MSME: Contribution to economy

- MSME sector constitutes more than 90% of total units (134 lakh).
- More than 8000 products
- MSEs Contribute about 45% of manufacturing
- Contributes around 40% of direct exports.
- Second largest source of employment, after agriculture (>340 lakh)

Source:SIDBI

MSME: Characteristics

- Promoters: Relatively new / unestablished
 - Local market / local resources
 - Ancillaries
 - **Organisational limitations: Proprietary**
 - High mortality & creditworthiness issues
 - Labour intensive – creates jobs
 - Nimble: With management bandwidth, can be more efficient than large enterprises
 - **Can be innovative, technology driven SMEs with growth potential**
 - **Extent of innovative, technology driven SMEs differentiates developed and developing countries**
 - **Starting point for evolution into large enterprises**
-

MSME: Challenges to sustainability

- According to Wharton School of Business, reasons for failure of small businesses are:
 - 32% because of inadequate research and development
 - 23% were bad ideas (re products and/of services offered)
 - 14% due to uncontrolled costs
 - 13% because of weak marketing strategies
 - 10% erred with bad timing
 - 8% succumbed to competitor activities
 - In USA, 80% of new businesses fail within three years
 - In New Zealand, 53% of new businesses fail within three years.
-

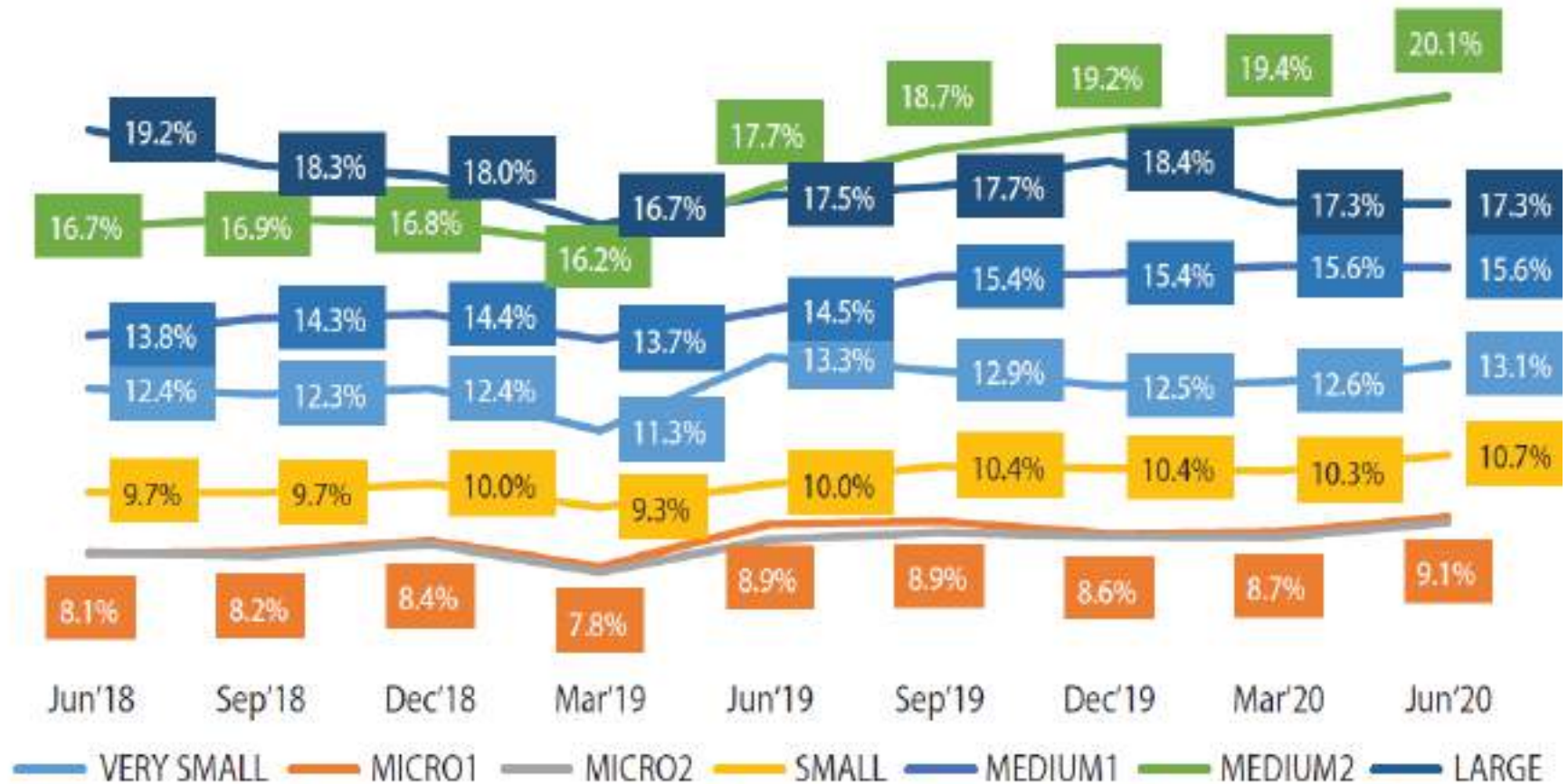
MSME: Challenges to sustainability

- According to Dun & Bradstreet:
 - Businesses with fewer than 20 employees have only a 37% chance of surviving four years (of business) and only a 9% chance of surviving 10 years.
 - Restaurants only have a 20% chance of surviving 2 years.
 - Of the failed business, 10% close involuntarily due to bankruptcy and the remaining 90% close because the business was not successful
 - Failure rate for new businesses is app. 70% to 80% in the first year and only about half of those who survive the first year will remain in business the next five years.
-

MSME: Challenges to sustainability

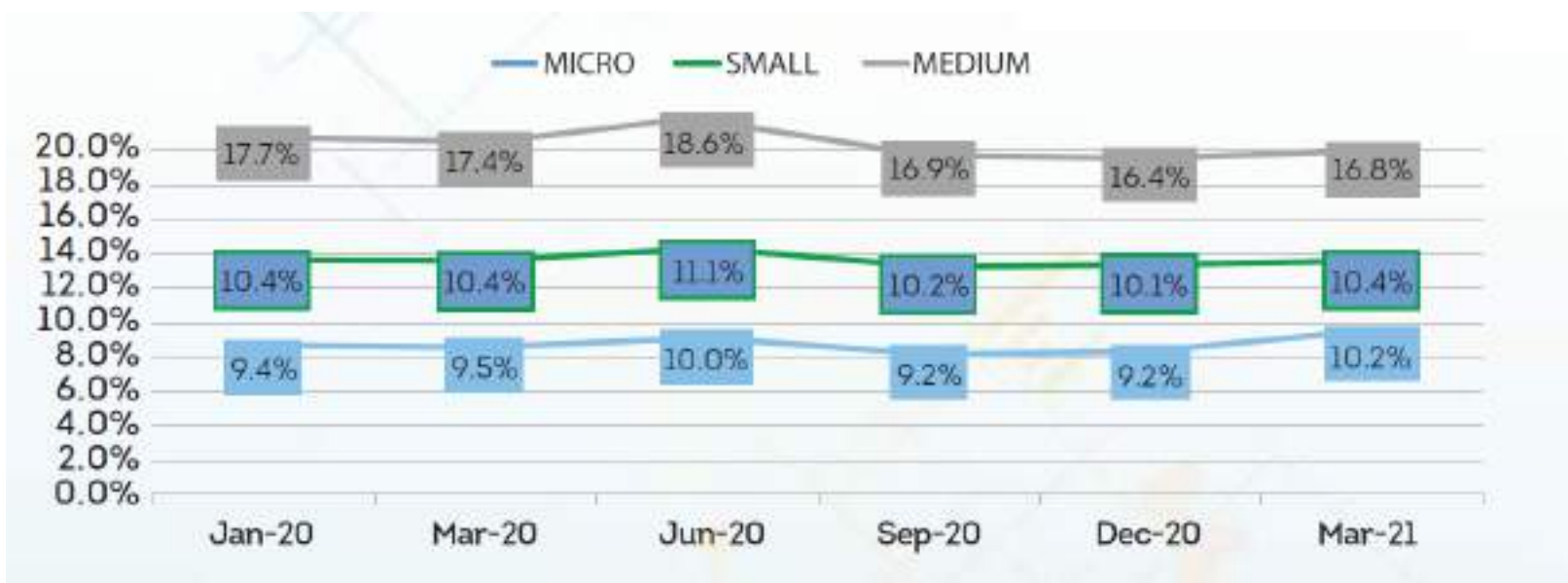
- People don't plan to fail, they fail to plan!
 - Good news is that there are tangible determinants of success of SMEs.
 - Thus SME strategies revolve around eradicating the causes of high failure of SMEs
 - SME development models across the world indicate that effective institutional structures do help SMEs
 - Let's see what institutional structures have done across the world
-

MSME: NPAs before Chinese virus



Source: MSME-Pulse-Edition-10-Oct-2020

MSME: NPAs after Chinese virus



Source: MSME-Pulse-Edition-June-2021

It is clear that the Chinese virus had had deleterious effect on MSMEs

MSME: NPAs after Chinese virus

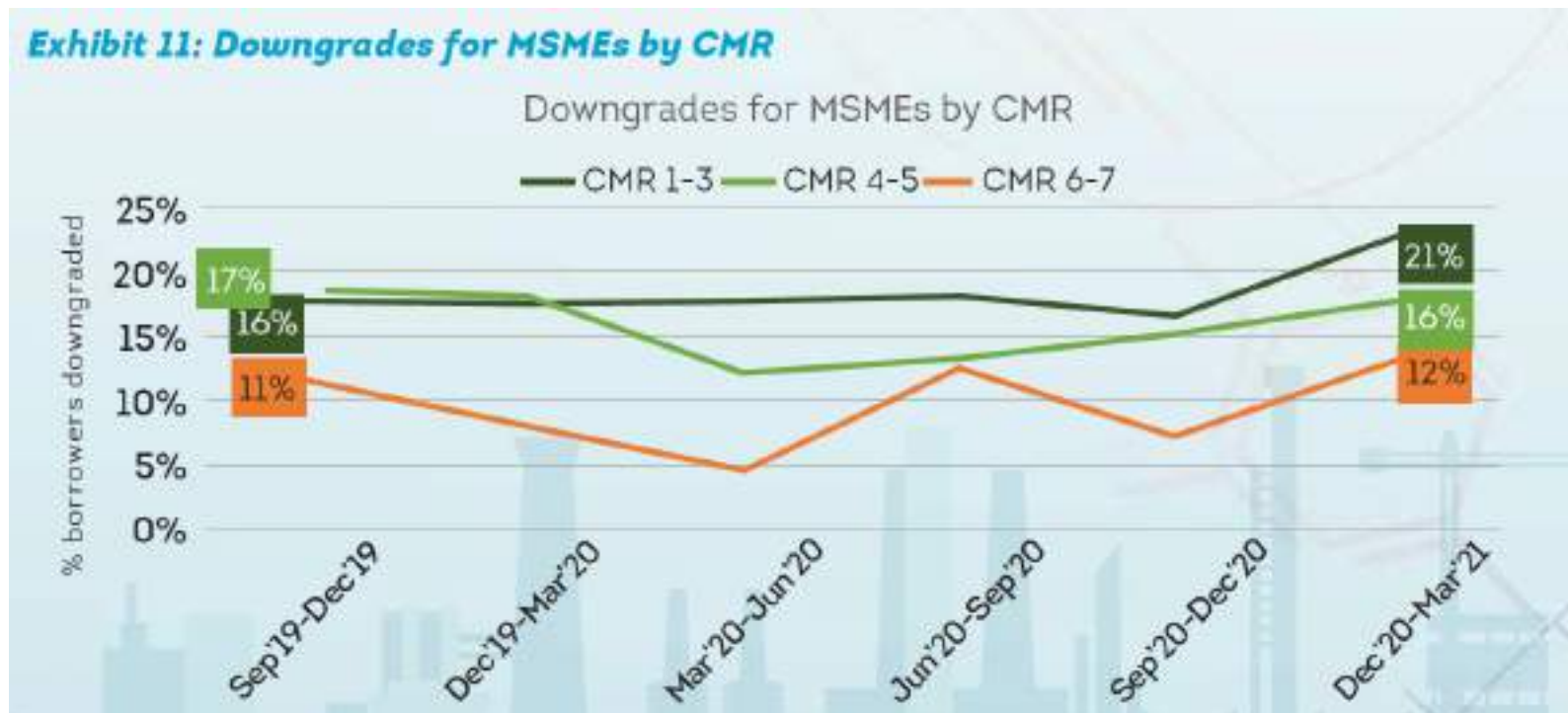
Exhibit 10: Transition Matrix of CMR from Mar'20 to Mar'21

		CMR as of Mar'21				Downgrades	Upgrades
		CMR 1-3	CMR 4-5	CMR 6-7	CMR 8-10		
CMR as of March '20	CMR 1-3	68%	21%	7%	4%	32%	
	CMR 4-5	21%	53%	16%	10%	26%	21%
	CMR 6-7	6%	22%	57%	15%	15%	28%
	CMR 8-10	1%	3%	18%	78%		22%

Source: MSME-Pulse-Edition-June-2021

This further shows that the Chinese virus had had deleterious effect on MSMEs

MSME: NPAs after Chinese virus



- This entails special efforts to resolve MSMEs
- Towards this, while the RBI has extended benefits to MSMS, for a sustainable resolution PIRP has been introduced in IBC
- Let's understand the rationale for pre-packaged plans

Let's discuss the steps taken by the government for mitigating MSME's financial distress and RBI schemes now. These have implications for resolution of MSMEs also under PIRP

Government's steps to combat NPAs in MSME

- Since the Chinese virus pandemic has affected the scale of MSME operations and their profitability, especially small businesses, the government has taken significant steps
- SIDBI is implementing several Government of India initiatives towards quick response to COVID 19. These include:
 - Direct Finance,
 - Institutional Finance,
 - Fund of Funds
 - Promotion and Development operations.
- The timely liquidity support to Banks, NBFCs & MFIs under the Rs.15,000-crore Special Liquidity Facility, support to MSMEs through
 - SAFE,
 - SAFE Plus,
 - TWARIT and
 - LIQUID schemes, and
 - Supporting livelihoods through activities under P&D and CSR

The SIDBI Schemes can be accessed from: <https://sidbi.in/en/products>

Government's steps to combat NPAs in MSME

Hon'ble Finance Minister in the press conference on June 28, 2021 made positive announcements for the industry including MSME

- **Guarantee will be provided to Scheduled Commercial Banks for loans to new or existing NBFC-MFIs or MFIs for on lending upto Rs 1.25 lakh to approximately 25 lakh small borrowers**
 - Interest Rate on Loans from banks to be capped at MCLR plus 2%
 - Maximum loan tenure 3 years, 80% of assistance to be used by MFI for incremental lending, interest at least 2% below maximum rate prescribed by RBI
 - Focus on new lending, not repayment of old loans
 - Loans to borrowers to be in line with extant RBI guidelines such as number of lenders, borrower to be member of JLG, ceiling on household income & debt
 - **All borrowers (including defaulters upto 89 days) eligible**
 - **Guarantee cover for funding provided by MLIs to MFIs/NBFC-MFIs till March 31, 2022 or till guarantees for an amount of Rs.7,500 crore are issued, whichever is earlier.**
-

MSME restructuring

- Resolution of distress loan entails realistic estimation of cash flow and serviceable debt level over reasonable time
 - The unserviceable i.e. unsustainable debt is required to be reduced by write off / conversion of a part into equity (debt & equity restructuring)
 - In asset restructuring, sale of illiquid assets should be limited so that the company retains its going concern value
 - The exercise requires reassessment of the business prospects and realistic determination of viability of the business
 - This requires expert inputs / team work
 - Hence RBI has been proactive in formulating policies for restructuring
 - Timely distress resolution ensures minimum damage. Hence RBI policy recommends early detection and resolution of distress
-

MSME restructuring

- RBI board passed a resolution in in November 2018 to consider a scheme of restructuring of stressed standard assets of MSME borrowers with aggregate credit facilities of up to ₹ 25 Crore
- Subsequently, RBI has notified a one-time measure permitting restructuring of stressed MSME accounts and save them from turning to NPAs

Eligible MSMEs

- GST registered/ exempted MSMEs
 - Aggregate exposure of Banks and NBFCs (all facilities) as on 1st January 2020 should be less than ₹ 25 Crore
 - Account must be Standard from 1st January 2020 till implementation of restructuring but moving towards becoming an NPA
-

MSME restructuring – Covid-19

DBR.No.BP.BC.18/21.04.048/2018-19

January 1, 2019

- One-time restructuring of existing loans to MSMEs classified as ‘standard’ without a downgrade in the asset classification, subject to:
 - GST registration where applicable overall exposure not exceeding Rs. 25 crore,
 - Completion of necessary agreements creation / perfection of security etc.
 - Provision of 5% till completion of “specified period” of one year after the payment of first instalment of interest or principal

RBI/2019-20/160 DOR.No.BP.BC.34/21.04.048/2019-20

February 11, 2020

- One-time restructuring of MSME advances as per circular dated 1/1/2019 extended for borrowers in default but were standard asset as on January 1, 2020 and continue to be classified as a ‘standard asset’ till the date of implementation of the restructuring implemented on or before December 31, 2020.
-

MSME restructuring – Covid-19

RBI/2019-20/186 DOR.No.BP.BC.47/21.04.048/2019-20

March 27, 2020

- **Rescheduling of Payments – Term Loans and Working Capital Facilities:** Three month moratorium allowed for all instalments falling due between March 1, 2020 and May 31, 2020
- **Easing of Working Capital Financing:** Recalculation of drawing power allowed by reducing the margins and/or by reassessing the working capital cycle
- Not treated as concession under Prudential Framework. So no asset classification downgrade.
- Asset classification to be determined on the basis of revised due dates and the revised repayment schedule.
- Working capital facilities where relief is provided, SMA and the out of order status to be evaluated considering the application of accumulated interest immediately after the completion of the deferment period as well as the revised terms, and permitted in terms.
- ~~Reschedulement of principal / interest, will not qualify as a default~~

Why Pre-Packs?

- Pre-packs have been quite successful in UK and other countries.
 - According to a study, in UK, survival of pre-packs has been 7% higher than for business sales
 - Pre-packs are faster
 - Pre-pack sales to “connected parties” can enhance realized value if competition is fostered. In UK, over 60% pre-packs are sold to connected parties
 - In UK, there is no significant difference between pre-packs and business sales
 - Pre-packs have been very effective in employment protection in UK
 - In the US, pre-packs have enabled firms to be restructured in a controlled manner, and reduced liquidation significantly.
 - The problem of phoenix syndrome has been fixed with efficient filter i.e. Section 29A with specific reliefs to MSME promoters (section 240A)
 - Pre-packs, with least turn-around time can be a remedy for delays in CIRP due to AA’s inability to approve resolution plans
-

SME resolution – Why Pre-Packs?

- Can pre-packs help resolution of distressed MSMEs?
- Let's see the figures first.
- U K Sinha Committee reports MSME exposure of the system at Rs 17.4 Trillion as at 31/03/2019:

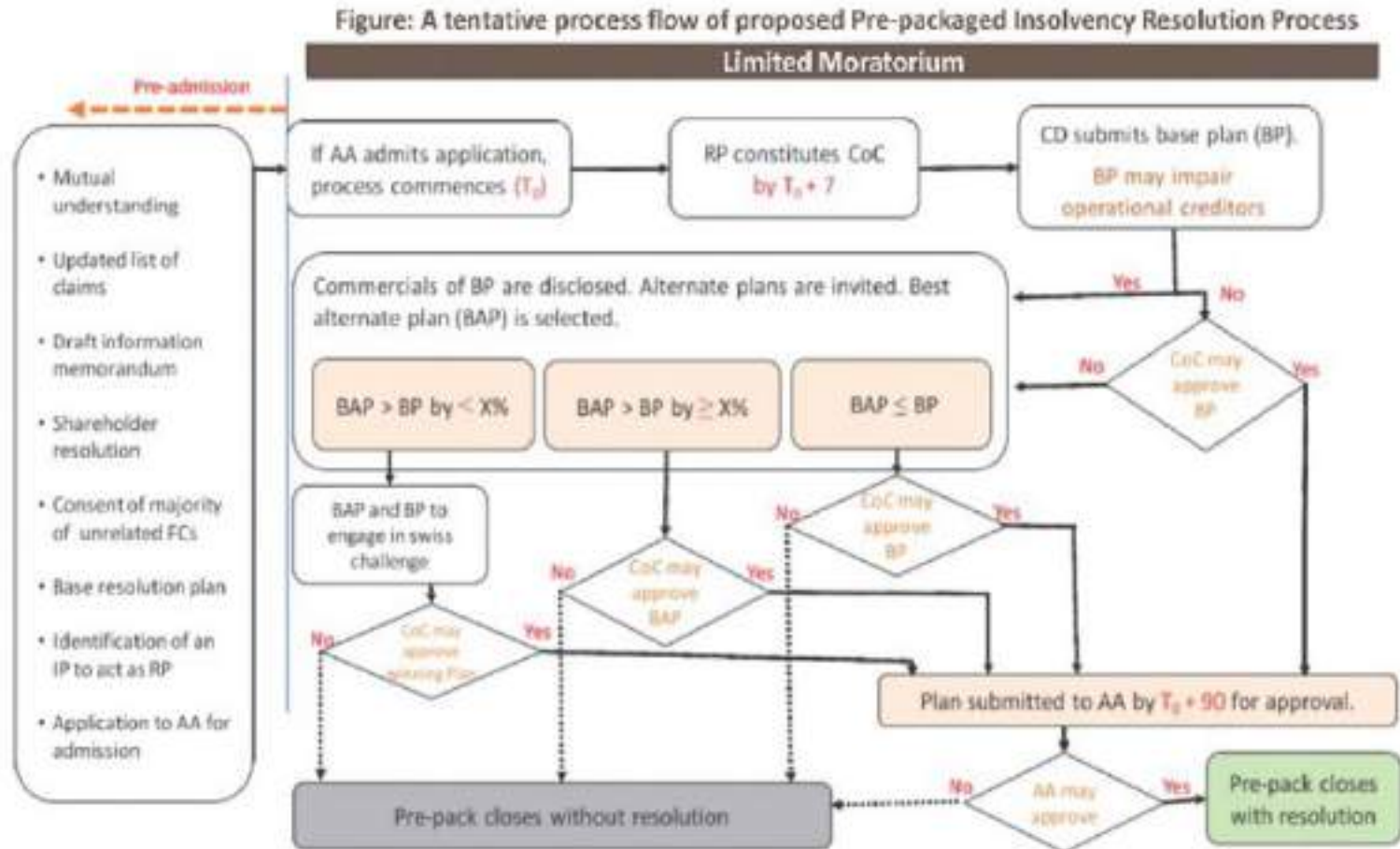
PSBs	Rs 9.3 Trillion	Size of Loan@	Total o/s@
Pvt SBs	Rs 5.7 Trillion	< 100 Lacs	Rs 4.3 Trillion
Foreign Banks	Rs 0.7 Trillion	100 to 2500 Lacs	Rs 10 Trillion
Total SCB	Rs 15.7 Trillion	>2500 Lacs	Balance exposure
NBFC	Rs 1.6 Trillion	@ TransUnion CIBIL data	
Total	Rs 17.4 Trillion		

- MSMEs number 63.38 million enterprises.
- MSMEs contribute 45% of manufacturing output, over 40% of exports, over 28% of the GDP and employ about 111 million people
- NPA level in this sector is reported to be app. 9%.
- NPAs in MSME sector have also resulted from credit gap of around Rs. 26 trillion of which 90% relates to Micro and Small Enterprises

SME resolution – Why Pre-Packs?

- Lockdown's deleterious impact on GDP and employment can be mitigated if MSME, particularly distressed SMEs are resolved under IBC.
 - Declaration of any borrower as NPA destroys the business / value irrespective of intrinsic viability
 - Pre-packs for distressed SMEs, apart from being faster can be used for acquisition and merger to ensure viable / optimum size of the entity post resolution
 - As a part of MSME resolution, the RBI should revisit its guidelines on "*Provision for diminution in the fair value of restructured advances*" for MSMEs
 - Decades of studies on resolving SME distress have not yielded results. IBC for SME resolution could aid timely resolution
 - In April 2009, the PIRP regulations were released. Can these achieve what other countries have achieved? Let's see.
-

IBBI's PIRP diagram



PIRP provisions

Section 54A: CD's eligible for PIRP

- MSMEs under sub-section (1) of section 7 of the Micro, Small and Medium Enterprises Development Act, 2006
- Default of Rs. 10 lakhs or above
- No earlier PIRP or CIRP
- No liquidation order
- **Eligible u/s 29A**
- 66% of more by value of unrelated financial creditors have proposed name of RP
- Majority of directors / partners declare that:
 - **CD will file application for start of PIRP within 90 days**
 - PIRP is not meant to defraud anyone
 - Give name of the RP to be appointed as RP
- Special resolution of CD to apply for PIRP
- **Approval from 66% unrelated financial creditors** for filing PIRP application (or other creditors in case financial creditors do not exist)
- For approval from 66% unrelated financial creditors to file PIRP application, **Base Resolution Plan** as per section 54K is submitted.

PIRP provisions

Section 54B: Duties of RP before initiation of PIRP

- Preparation of report on CD's compliance with section 54A and **Base Resolution Plan** as per section 54K
 - As per PIRP regulation 17, the report under clause (a) of sub-section (1) of section 54B shall be prepared in Form P8.
 - Other reports / duties **as may be specified**
 - RP's duties cease if CD fails to submit PIRP application within specified time or the application is rejected by the AA
 - Fee to RP will be fixed in a manner **as may be specified** and will form part of PIRP cost
-

PIRP provisions

Section 54C: Application to initiate PIRP

- Application to be filed in prescribed manner
 - Includes written consent of the RP
 - declaration regarding the existence of any avoidance transactions (preferential – section 43, undervalued – section 45, extortionate – section 50 and or fraudulent or wrongful trading – section 66 as may be specified
 - Information relating to books of accounts and other documents
 - Within 14 days of receiving application the AA must accept or reject the incomplete application (after giving 7-day notice to rectify the defect.
 - PIRP starts from the date of AA's order
-

PIRP provisions

Section 54D: Time limit for completion of PIRP

- 120 days from start of PIRP
- RP must submit CoC approved resolution plan to AA for approval within 90 days of PIRP start date
- If CoC does not approve resolution plan within the time limit, the RP must file application to AA for **termination of PIRP**

Section 54E: Time limit for completion of PIRP

- Moratorium u/s 14 applies till the end of PIRP
 - Appointment of RP
 - Public announcement
-

PIRP provisions

Section 54F: Time limit for completion of PIRP

DUTIES

- Constitute CoC, and convene / attend the CoC meetings
 - Confirm the list of claims submitted by the corporate debtor
 - Inform creditors regarding their claims as confirmed
 - Maintain an updated list of claims
 - Monitor management of the affairs of the corporate debtor
 - Inform the CoC in the event of breach of any IBC by the directors / partners
 - Prepare the **information memorandum** on the basis of the **preliminary information memorandum** submitted under section 54G
 - File applications for avoidance of transactions or fraudulent or wrongful trading (43, 45, 50, 66)
-
- Other duties as may be specified.

PIRP provisions

Section 54F: Time limit for completion of PIRP

POWERS

- All powers applicable in CIRP, plus,
 - Attending meetings of members, Board of Directors and committee of directors, or partners
 - Appointing accountants, legal or other professionals in such manner as may be specified
 - Take such other actions in such manner as may be specified
 - CD's personnel must extend all assistance and cooperation to the RP in his job. Section 19 will apply in case they do not cooperate
 - RP's fee to be determined in a manner as may be specified
-

PIRP provisions

Section 54G: Time limit for completion of PIRP

- Within **2 days** of the start of PIRP, the CD must submit to the RP:
 - List of claims, along with details of the respective creditors, their security interests and guarantees, if any, and;
 - **PIM containing information relevant for formulating a resolution plan**
 - If any person incurs **loss or damage** due to omission of any material information or inclusion of any misleading information in the list of **claims** or the PIM submitted by the CD:
 - The directors / partners or anyone who has authorised the list of claims or the PIM will be punishable u/s 77A
-

PIRP provisions

Section 54H: Management of affairs of CD

- During the PIRP, the management continues to vest with board of directors / partners

Section 54I: Committee of creditors

- Within seven days of the PIRP commencement date, the RP must constitute a CoC, based on the list of claims confirmed under clause (a) of sub-section (2) of section 54F
 - The composition of the CoC can be altered with updated claim list
 - First meeting of the CoC must be held within seven days of the constitution of the CoC
 - Section 21 applies mutatis mutandis
-

PIRP provisions

Section 54J: Vesting management of CD with RP

- If CoC with 66% or more votes resolves to vest the management with the RP
 - Based on this, the RP has to apply to the AA
 - If the AA is of the opinion that the affairs of the CD have been conducted in **fraudulent manner** or there has been mismanagement, it must pass order vesting the management with AA
 - Certain other sections relating to roles and duties of IRP / RP and CoC apply *mutatis mutandis*
-

PIRP provisions

Section 54K: Consideration and approval of resolution plan

- The CD must submit **Base Resolution Plan** within 2 days of start of PIRP and place to the CoC
 - CoC may seek revision in the **BRP**
 - Provisions of section 30 apply **mutatis mutandis**
 - CoC may approve the resolution plan if it does not impair claims of OCs
 - If the resolution plan impairs claims of OCs, the CoC must invite PRAs to submit resolution plans to compete with **Base Resolution Plan**
 - The RP must provide to the PRAs, basis for evaluation of resolution plans as approved by the CoC
 - The PRAs must fulfil criteria as may be laid down
 - Section 29 applies **mutatis mutandis**
-

PIRP provisions

Section 54K: Consideration and approval of resolution plan

- RP to examine resolution plan as per section 30(2) and present to the CoC
- CoC may approve resolution plan which is **significantly** better than **Base Resolution Plan**
- If the resolution plan is not **significantly** better than **Base Resolution Plan** and does not laid down criteria:
 - It can compete with the **Base Resolution Plan** subject to conditions as may be specified,
 - One of the two resolution plans must be selected and may be approved by the CoC with vote of 66% or more
- ~~The order of priority of the creditors should be as per section 53, keeping in view the security value and other requirements as may be specified~~

PIRP provisions

Section 54K: Consideration and approval of resolution plan

- If the resolution plan involves sacrifice from creditors:
 - The CoC may require promoters to dilute their shareholding / voting / control.
 - If the CoC does not adopt such dilution, it must record the reasons thereof, before approval
 - RP to submit the CoC approved resolution plan to AA for approval u/s 54K(15)
-

PIRP provisions

Section 54L: Approval of resolution plan

- If the AA is satisfied that the resolution plan meets the requirements u/s 30(2), it **must** approve it within 30 days of its submission
 - For AA's approval section 31 applies **mutatis mutandis**
 - If the AA finds that the resolution plan does not conform to the requirements, it can reject the plan and pass order u/s 54N within 30 days of its submission
 - Where section 54J(2) for mismanagement and fraudulent affairs of the CD applies and the CoC does not change the management of CD in the approved resolution plan, the AA must pass the order:
 - Rejecting the resolution plan
 - Terminate PIRP
 - Declare that PIRP cost will be included in liquidation cost
-

PIRP provisions

Section 54M: Appeal against order under section 54L

Any appeal against the order approving the resolution plan u/s 54L(1), must be on the grounds laid down in section 61(3)

Section 54N: Termination of PIRP

- Within 30 days of application of the RP filing application under:
 - Section 54K(12), or,
 - 54D(3)
- The AA must terminate PIRP and provide for continuation of PUFE proceedings
- In this case the CD must bear the PIRP cost
- If the CoC with 66% or higher votes resolves to terminate the PIRP, based on the application by the RP to this effect, the AA must pass the order terminating the PIRP

PIRP provisions

Section 54O: Initiation of PIRP

- If the CD is eligible for CIRP u/s 12(4), u/s 54K(4) or 54K(12) the CoC can resolve with 66% or more votes for initiation of CIRP
- Within 30 days of the RP's application, the AA must pass an order to:
 - Terminate PIRP
 - Appoint RP as IRP based on written consent
 - Declare for inclusion of PIRP cost as part of CIRP costs
- The AA's order is deemed to be order u/s 7

Section 54O: Application of provisions of Chapters II, III, VI, and VII

- Sections 24, 25A, 26, 27, 28, 29A, 32A, 43 to 51, and the provisions of Chapters VI and VII of this Part apply mutatis mutandis
-

PIRP regulations

- Ten chapters
 - I: Preliminary II: General III: Resolution professional
 - IV: Initiation of process V: Public announcement & claims
 - VI: Committee of creditors VII: Meetings of the Committee
 - VIII: Valuation and Information Memorandum
 - IX: Resolution Plan
 - X: Management of the affairs of the corporate debtor
 - Fifty-one regulations
 - Fourteen forms: P1 to P14
 - While the processes are similar to those of CIRP, the Swiss Challenge embedded in Chapter IX: Resolution plan approval is unique
-

Chapter IX: Resolution plan approval

- Let's recall section 54K which requires:
 - The CD must submit **Base Resolution Plan** within 2 days of start of PIRP and the RP must place to the CoC
 - CoC may seek revision in the **BRP** before inviting PRAs
 - CoC may approve the resolution plan if it does not impair claims of OCs
 - If the resolution plan impairs claims of OCs, the CoC must invite PRAs to submit resolution plans to compete with **Base Resolution Plan**
 - The RP must provide to the PRAs, basis for evaluation of resolution plans as approved by the CoC
 - Let's now see resolution plan evaluation process under Chapter IX of PIRP regulations
-

Chapter IX: Resolution plan approval

PIRP regulation 42: Scoring and improvement of resolution plans

- The CoC must approve the basis for evaluation resolution plans including:
 - Parameters to be adopted
 - The manner of applying such parameters, for evaluating a resolution plan to assign a score to the plan,
- The basis for evaluation of resolution plans must be disclosed in the invitation for resolution plans
- Let's analyse the illustrations given in PIRP regulation 42 and identify the appropriate parameters.
- Let's compare the measures for formulation of resolution plan under PIRP regulation 44 with CIRP regulation 36
- Finally let's discuss the incentives and disincentives for adoption of PIRP by the promoters

By

Rajendra M. Ganatra

BE(Mech. Engg), CAIIB, CFA (India), Ph.D.

Email: rmganatra@gmail.com
