

Why Firms Reduce Debt: Insights from India's Bankruptcy Framework and Institutional Environment

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Abstract

Over the past two decades, Indian firms have exhibited a consistent trend of corporate deleveraging, marked by a gradual reduction in reliance on debt financing. This article explores the underlying drivers of this shift, focusing on the rising significance of bankruptcy costs and persistent institutional constraints within the Indian financial system. While traditional capital structure theories emphasise the benefits of leverage, the Indian experience reveals a more cautious corporate approach shaped by legal reforms, credit market frictions, and heightened perceptions of financial distress. By examining real-world corporate cases and broader financial developments, the article argues that deleveraging in India is not merely cyclical but structural in nature. The findings highlight the need for a balanced financial ecosystem that supports both stability and growth, while also offering insights for policymakers and corporate decision-makers navigating an increasingly risk-aware environment.

Keywords: Debt financing, Corporate deleveraging, IBC Code, Bankruptcy Costs, Institutional Environment, financial system

Introduction

Over the last two decades, Indian corporates have undergone a quiet but profound transformation in the way they finance their growth. While traditional corporate finance theory advocates the strategic use of debt to enhance shareholder value, a growing number of Indian firms have steadily reduced their dependence on borrowed funds. This shift toward corporate deleveraging is neither accidental nor temporary—it reflects a deeper structural change in how firms perceive risk, opportunity, and survival in an evolving economic environment.

At first glance, this trend appears counterintuitive. India is one of the fastest-growing major economies in the world, with expanding markets, rising consumption, and increasing integration with global value chains. In such a setting, one would expect firms to aggressively use debt to scale operations and capture growth opportunities. However, the reality is more complex. Beneath the surface lies a combination of rising bankruptcy costs and persistent institutional constraints that have fundamentally altered corporate financing decisions. These factors have reshaped managerial risk preferences, pushing firms toward more conservative and resilient financial strategies.

The Reality Behind Bankruptcy Costs in India

In theory, bankruptcy costs are often treated as distant or unlikely events—something that firms can manage or avoid through careful planning. In practice, especially in India, the consequences of financial distress are far more immediate, visible, and severe. Bankruptcy is not just a legal process; it represents a multidimensional shock that affects a firm's reputation, operations, stakeholder relationships, and long-term viability.

The experience of Essar Steel offers a powerful example. Once a major player in India's steel industry, the company entered insolvency proceedings under the Insolvency and Bankruptcy Code (IBC). The resolution process was lengthy and complex, ultimately leading to its acquisition by ArcelorMittal. While the case is often cited as a success story for creditors, it also highlighted the significant loss of control faced by original promoters and the uncertainty surrounding distressed firms. The process underscored how financial distress can fundamentally alter ownership structures and strategic direction.

Similarly, Bhushan Steel, which was eventually acquired by Tata Steel, demonstrated how excessive leverage combined with adverse market conditions can quickly push firms into financial distress. These cases illustrate that

the costs of bankruptcy extend beyond measurable financial losses to include intangible but critical factors such as credibility, managerial autonomy, and market position. As a result, corporate managers have become increasingly sensitive to downside risks. Debt is no longer evaluated solely on its cost advantages; instead, firms are incorporating the expected cost of financial distress into their decision-making frameworks. This shift has contributed significantly to the growing preference for lower leverage.

The IBC Framework: Strengthening Discipline, Increasing Caution

The introduction of the Insolvency and Bankruptcy Code marked a turning point in India's financial ecosystem. By establishing a time-bound insolvency resolution process and strengthening creditor rights, the IBC aimed to address inefficiencies in the earlier system and improve credit discipline. From a macroeconomic perspective, the reform has yielded positive outcomes. Recovery rates have improved, resolution timelines have shortened, and the overall transparency of the insolvency process has increased. These developments have strengthened the confidence of lenders and investors in the financial system.

However, from the perspective of borrowing firms, the IBC has also increased the perceived severity of financial distress. Promoters now face a credible threat of losing control over their firms in the event of default. This has introduced a new dimension to corporate risk assessment, where the consequences of failure are not only financial but also personal and reputational. Consequently, firms have become more cautious in their borrowing behaviour. The emphasis has shifted toward maintaining financial flexibility, preserving ownership, and avoiding situations that could trigger insolvency proceedings. This behavioural change has played a crucial role in accelerating the deleveraging trend.

Institutional Constraints: The Invisible Barrier

While bankruptcy costs provide a compelling explanation for deleveraging, they do not fully capture the broader structural challenges faced by Indian firms. Institutional constraints within the financial system continue to shape corporate financing decisions in significant ways. One of the most persistent challenges is the limited development of the corporate bond market. Unlike advanced economies, where firms can diversify their funding sources, Indian companies remain heavily reliant on bank financing. This dependence becomes problematic when banks themselves face balance sheet constraints.

Following the non-performing asset (NPA) crisis, major public sector banks such as the State Bank of India adopted a more risk-averse lending approach. Credit appraisal standards were tightened, and exposure to leveraged sectors was reduced. This shift, while necessary for financial stability, has restricted the availability of credit to firms. The collapse of Infrastructure Leasing & Financial Services further highlighted the systemic risks associated with excessive leverage and weak institutional oversight. The event triggered liquidity concerns across the financial system and led to tighter credit conditions, particularly for infrastructure and non-banking sectors. In such an environment, deleveraging becomes less of a strategic choice and more of an adaptive response. Firms adjust their capital structures not only based on internal considerations but also in response to external constraints that limit their access to affordable financing.

Corporate Strategy: Evidence from Indian Firms

The impact of these structural forces is clearly visible in the strategies adopted by leading Indian corporations. Firms are increasingly prioritising balance sheet strength and financial resilience over aggressive expansion driven by debt.

Reliance Industries provides a prominent example. By raising substantial equity capital and monetising assets, the company successfully reduced its net debt position and strengthened its financial flexibility. This strategic shift reflects a forward-looking approach to risk management. Similarly, Tata Motors has focused on deleveraging to stabilise its financial position following periods of global uncertainty. Through improved cash flow management and liability restructuring, the company has worked toward restoring investor confidence. In the telecommunications sector, Bharti Airtel has adopted a balanced strategy that combines equity infusion with gradual debt reduction. This approach highlights the importance of maintaining sustainable leverage levels while continuing to invest in growth. These examples indicate that deleveraging is no longer viewed as a reactive measure but as an integral component of long-term corporate strategy.

Is Deleveraging Good or Bad for Growth?

Macroeconomic Implications: Stability vs. Growth Trade-off

Economic Growth

The trend of corporate deleveraging in India presents a fundamental trade-off between financial stability and economic growth. On the one hand, lower leverage enhances the resilience of firms and the broader financial system. On the other hand, excessive caution in borrowing may constrain investment and slow down economic expansion. This dual impact makes deleveraging a complex phenomenon with both short-term benefits and long-term challenges.

Firms' Financial Stability

From a stability perspective, the benefits of deleveraging are significant. Firms with lower debt levels tend to have stronger balance sheets, characterised by improved liquidity, lower financial obligations, and greater capacity to absorb economic shocks. This resilience becomes particularly important during periods of uncertainty, such as global financial crises or domestic slowdowns, where highly leveraged firms are more vulnerable to distress. Stronger balance sheets also enhance investor confidence, as firms are perceived to be financially disciplined and less risky.

Reduction in Systematic Risk

A related advantage is the reduction in systemic risk. When a large number of firms reduce leverage simultaneously, the probability of widespread defaults declines. This, in turn, reduces the burden on the banking system, which has historically faced stress due to high levels of non-performing assets (NPAs). A less leveraged corporate sector contributes to overall financial stability by minimising the risk of contagion, where the failure of one firm or sector triggers broader disruptions across the economy.

Credit Quality

In addition, deleveraging contributes to improved credit quality. Banks and financial institutions benefit from lending to firms with stronger financial positions, as the likelihood of default decreases. This improves asset quality in the banking sector and enhances its ability to support future lending. Over time, a healthier credit environment can strengthen the foundations of the financial system.

Private Investment

However, these benefits come with important trade-offs. One of the most significant concerns is the potential decline in private investment. Debt financing plays a crucial role in funding large-scale projects, particularly in sectors such as infrastructure, manufacturing, and energy. When firms become overly cautious about borrowing, they may postpone or scale down investment plans, leading to slower capital formation. This can have ripple effects on employment, productivity, and overall economic growth.

Slower Credit Growth

Closely related is the issue of slower credit growth. As firms reduce their demand for loans, the transmission of monetary policy through the credit channel becomes weaker. Even when central banks lower interest rates to stimulate economic activity, the intended effect may be muted if firms are unwilling to borrow. This reduces the effectiveness of monetary policy as a tool for managing economic cycles.

Impact on Economic Policies

Another important implication is the reduced effectiveness of monetary policy transmission. In a highly leveraged economy, changes in interest rates have a direct impact on borrowing and investment decisions. However, in a deleveraged environment, firms rely more on internal funds rather than external debt. As a result, policy rate cuts may not translate into increased investment, limiting the central bank's ability to influence economic activity.

Access to Capital

These challenges are particularly pronounced in capital-intensive sectors, where access to debt is essential for growth. Industries such as infrastructure, power, and transportation require substantial upfront investment with long gestation periods. When access to debt financing is constrained, projects may be delayed, scaled down, or even abandoned. This not only affects sectoral growth but also has broader implications for economic development, as infrastructure plays a critical role in supporting industrial expansion and improving productivity.

In this context, the key challenge for policymakers is to strike a balance between promoting financial stability and ensuring adequate investment for sustained growth. While deleveraging reduces risk, it should not lead to excessive conservatism that hampers economic dynamism. A well-functioning financial system must enable firms to access capital efficiently while maintaining prudent risk management practices.

The Way Forward: Balancing Risk and Opportunity

The challenge for India lies in creating a financial ecosystem that supports both disciplined borrowing and growth-oriented investment. Policymakers must focus on strengthening financial institutions while also improving access to diverse sources of capital. Developing a deeper corporate bond market, enhancing the efficiency of legal processes, and improving credit flow to productive sectors are critical steps in this direction. Equally important is the need for firms to adopt sophisticated financial strategies that balance leverage with flexibility and resilience.

Conclusion

Corporate deleveraging in India is not merely a short-term adjustment—it is a reflection of deeper structural changes in the financial and institutional landscape. Rising bankruptcy costs, particularly in the post-IBC era, have made financial distress more consequential, while institutional constraints continue to limit access to external finance.

The experiences of firms such as Essar Steel, Bhushan Steel, Reliance Industries, and Tata Motors illustrate how these dynamics operate in practice. Together, they point toward a broader shift in corporate mindset—one that prioritises stability, flexibility, and long-term sustainability over aggressive leverage.

As India continues its economic ascent, addressing these structural challenges will be essential. The objective is not to eliminate debt but to create an environment where firms can use it effectively without being exposed to disproportionate risks.

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