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AN OVERVIEW OF SECURITIZATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTEREST ACT, 2002 (SARFAESI) AND ITS IMPACT ON NPA

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Abstract

In order to address the rising concerns about Non-Performing Assets (NPAs) in the banking industry, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) was enacted in India. By making it easier for financial assets to be rebuilt and securitized, this Act gives financial institutions the ability to effectively recover bad debts. The principal aim of the SARFAESI Act is to facilitate the enforcement of security interests by banks and financial institutions without the need for judicial intervention, hence speeding the process of recovery.

In order to address the NPA situation, this paper focusses on the SARFAESI Act and gives a thorough summary of its main features of the Act including asset securitization, the creation of asset reconstruction corporations (ARCs), and the enforcement of security interests by creditors. This study offers a thorough analysis of SARFAESI, including information on how it operates and how it affects non-performing assets.

Keywords – Non-performing assets (NPAs), SARFAESI Act, 2002, financial institutions, debts, Asset Reconstruction Corporations (ARCs), creditors.

Introduction

To increase the effectiveness of lending and recovery procedures, the Indian banking industry has implemented a number of changes. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, is one of the most important legal frameworks adopted to address the growing non-performing assets (NPAs) (SARFAESI Act). In order to address the issue of growing non-performing assets (NPAs), the Act was passed with the intention of giving banks and other financial institutions the capacity to swiftly and outside of judicial involvement collect bad debts.

According to the Reserve Bank of India (RBI), "the gross non-performing assets in Indian banks, specifically in public sector banks, are valued at around Rs 400,000 crores which represents 90% of the total NPA in India, with private sector banks accounting for the remainder. An asset becomes non-performing when it ceases to generate income for the bank. In India, a NonPerforming Asset (NPA) is broadly defined as one with interest or principal repayment installment unpaid for more than 90 days prior to 1993".[1] "A lot of time was therefore spent in the judicial process before banks could have any chance of recovery on their loans. On average, a civil suit decision took anywhere between 5 to 7 years. Under the Recovery of Debts to Banks and Financial Institutions Act 1993, Debt Recovery Tribunals (DRTs) were set up for recovery of loans of banks and financial institutions. This led to speedy recovery of loans in about 1 years' time as against the average time of 5 to 7 years required in civil suits. While initially the DRTs performed well, their progress suffered as they got overburdened with the huge volume of cases referred to them. To speed up the process of recovery from NPAs, The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) Act was enacted in 2002 for regulation of securitization and reconstruction of financial assets and enforcement of security interest by secured creditors".[2] The SARFAESI Act empowers Banks / Financial Institutions to recover their nonperforming assets without the intervention of the Court.

[1] Greeshma Francis, "An Overview of SARFAESI Act and Its Impact on NPA," 8 *Paripex-Indian Journal Of Research* 27 (2019).

[2] Greeshma Francis, "An Overview of SARFAESI Act and Its Impact on NPA," 8 *Paripex-Indian Journal Of Research* 27 (2019).

Background of SARFAESI Act, 2002

A major obstacle for India's banking sector in the 1990s was the increase of non-performing assets (NPAs). The viability of the banking industry was jeopardized by non-performing assets (NPAs), which are loans or advances for which the principle or interest payment was delinquent for a certain amount of time. Upon the liberalization of the economy in the early 1990s, the Indian government saw that a legal framework was necessary to expedite the recovery of debts that had defaulted. Even in situations where the borrower has pledged security, lenders had to endure drawn-out legal procedures in order to retrieve assets prior to the SARFAESI Act. Since recovery through legal remedies was unclear and time-consuming, the delay in loan recovery was contributing to an increase in non-performing assets (NPAs). SARFAESI was established as a result of recommendations made by the Narasimha Committee II (1998) and the Andhyarujina Committee on bankruptcy legislation to strengthen the rights of secured creditors in order to address this problem.

With the implementation of the SARFAESI Act in 2002, banks and other financial institutions gained substantial authority to recoup bad debts through the direct auction of assets pledged as collateral, eliminating the need for court participation.

Overview of SARFAESI Act, 2002

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 allows banks and other financial institutions to auction residential properties or any other property, kept as a collateral, by a borrower, when the borrower fails to repat the amount taken as loan, thus, enabling bank to reduce their Non-Performing Assets (NPAs) through methods of recovery and reconstruction.

The SARFAESI Act, 2002 was circulated for the following reasons:

- To regulate and scrutinize the financial assets
- To enforce the security interest
- Matters connected therewith or incidental thereto.
- To empower lenders to seize and sell secured assets of the borrower without the need to approach courts or tribunals

The SARFAESI Act, 2002 vide the enforcement of the Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016, further leading to amendment of following four Acts:

i. Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) ii. Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI) iii. Indian Stamp Act, 1899 iv. Depositories Act, 1996

The SARFAESI Act, 2002 delas with the following:

i. Reserve Bank of India regulates Registration and Regulation of Asset Reconstruction Companies (ARCs) and other financial institutions' assets irrespective of the securities being beneficial.
ii. Encouragement of easy transferability of financial assets by the ARC to buy bank and financial institution financial assets by issuing bonds, debentures, or any other security convertible into a debenture[3]. iii. Entrusting the Asset Reconstruction Companies to raise funds by issue of security receipts to qualified buyers.[4]
iv. Assisting in the reconstruction of financial assets obtained by the use of powers intended to be granted to banks and other financial organisations, such as the ability to replace management, enforce securities, and other authority.
v. Presentation of any asset reconstruction or securitization firm that is registered as a public financial institution with the Reserve Bank of India.[5]
vi. Any kind of security, such as a mortgage or change on real estate, is defined as a "security interest" when it is granted in exchange for the timely repayment of any loans provided by banks or other financial institutions.

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[3] Mayashree Acharya, "SARFAESI ACT, 2002 – Applicability, Objectives, Process, Documentation", *available at: https://cleartax.in/s/sarfaesi-act-2002* (last visited on September 12, 2024).
[4] Mayashree Acharya, "SARFAESI ACT, 2002 – Applicability, Objectives, Process, Documentation", *available at: https://cleartax.in/s/sarfaesi-act-2002* (last visited on September 12, 2024).
[5] Mayashree Acharya, "SARFAESI ACT, 2002 – Applicability, Objectives, Process, Documentation", *available at: https://cleartax.in/s/sarfaesi-act-2002* (last visited on September 12, 2024).

The recovery process under the Act is detailed and well structured to ensure transparency and fairness. Following are the provisions to enforce the security interest:

i. S.13(2) . Demand Notice – “The secured creditor must issue a demand notice to the defaulting borrower, requiring the discharge of liabilities within 60 days. The notice should specify the amount due and the actions that the creditor intends to take in case of non-compliance.”

ii. S.13(4). Possession Notice – “If the borrower fails to comply with the demand notice within the stipulated period, the creditor can take possession of the secured assets and issue a possession notice. This notice should inform the borrower about the taking over of the asset and provide details about the next steps.”

The sale of immovable assets under the SARFAESI Act withal is governed by following rules of the Security Interest (Enforcement) Rules, 2002:

i. Rule 8 – “This rule outlines the procedure for taking possession of the immovable property, including the requirement to issue a public notice about the intended sale. The notice must be published in two leading newspapers, one of which should be in the local language, and affixed on the property and other conspicuous places.”

ii. Rule 9 – “This rule specifies the detailed process for the sale of the asset, including its valuation, auction, and issuance of a sale certificate to the buyer. The sale should be conducted in a transparent manner, ensuring that the highest possible value is realized for the asset.”

The Act also provides the right to appeal against the actions of secured creditors, ensuring a fair and balanced approach to debt recovery. The following are the sections for appeal under the Act:

i. S.17 – “This section allows the borrower to file an appeal before the DRT against measures taken by the secured creditor under s. 13(4). The appeal must be filed within 45 days of the date on which the measure was taken. The DRT has the authority to examine whether the secured creditor has complied with the provisions of the Act and the Rules, and it can grant relief if the borrower's rights have been violated.”

ii. S.18 – “If the borrower is aggrieved by the decision of the DRT, they can further appeal to the Debt Recovery Appellate Tribunal (**‘DRAT’**). The appeal to the DRAT must be filed within 30 days of the DRT’s order. Additionally, borrowers can approach

the High Courts through writ petitions under a. 226 of the Constitution of India for any violation of their fundamental rights."

Following are the grounds[6] on which borrowers can appeal:

i. Noncompliance with the procedures laid in the Act.
ii. Failure to issue notice or possession notice, which is mandatory under the Act.
iii. Disputes regarding the valuation of the secured assets, may result in unfair valuation
iv. Arbitrary actions by the secured creditor.

The Apex court heard a case challenging the constitutional validity of the SARFAESI Act in ***Mardia Chemicals v. Union of India***[7][8], mainly on the grounds that identical statutes previously existed. Furthermore, it was argued that the clauses under sections 13 and 17 were arbitrary and illogical, making them unconstitutional. The Supreme Court noted that even while the legislation has a few strict and severe provisions, this does not mean that the statute is unconstitutional on its own, particularly given the goals the legislation aims to accomplish. The Gujrat High Court also upheld the constitutionality of sections 13, 17, 18, and 19 ***MR Utensils v. UOI***[8].

In the case of ***Pandurang Ganpati Chaugule and Others v. Vishwasrao Patil Murgud Sahakari Bank Ltd.***[9], the Hon'ble SC expanded the ambit of the SARFAESI Act by stating that cooperative societies ought to be acknowledged as banks under the Act. Furthermore, the Supreme Court decided in the ***Transcore v. Union of India***[10] judgement that non-banking financial firms (or "NBFCs") are subject to the SARFAESI Act. The Act's scope was further expanded by this ruling, which gave NBFCs the similar rights and authority as banks to pursue defaulting borrowers for unpaid loans.

<u>What are Non-performing Assets (NPAs)?</u>

NPAs as defined under S. 2(o) of the SARFAESI Act, 2002 as:

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[6] *Available at:* https://www.metalegal.in/post/a-bank-s-comrade-an-overview-of-the-sarfaesi-act (last visited on September 12, 2024).
[7] AIRONLINE 2004 SC 948.
[8] SCC OnLine Guj 367.
[9] AIRONLINE 2020 SC 527.
[10] AIR 2007 SC 712.

"*an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset,—*

(a) in case such bank or financial institution is administered or regulated by any authority or body established, constituted or appointed by any law for the time being in force, in accordance with the directions or guidelines relating to assets classifications issued by such authority or body;

(b) in any other case, in accordance with the directions or guidelines relating to assets classifications issued by the Reserve Bank;"[11]

The Reserve Bank of India (RBI) defines Non-Performing Assets (NPAs) as any advance or loan that is overdue for more than 90 days.

In a circular of 2007 RBI said, "An asset becomes non-performing when it ceases to generate income for the bank." [12]

The 90-day overdue standard for identifying non-performing assets (NPAs) was introduced by the
RBI in order to better align with global practices. It became effective for the year that ended on March 31, 2004. Non-performing assets also come in several varieties, depending on how long they have been non-performing assets (NPAs).

A bank's revenue and profitability decline, its ability to lend decreases, and the likelihood of loan defaults and write-offs increases as the percentage of non-performing assets (NPAs) in its loan portfolio increases. The Reserve Bank of India and the government have implemented a number of measures to manage and lower the quantity of non-performing assets (NPAs) in the banking industry in order to solve this problem.

<u>Types of NPAs</u>

The types or the categories of NPAs depend upon how long they remain in the NPA category.

[11] The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 [12] *Available at*: https://www.rbi.org.in/commonman/Upload/English/Notification/PDFs/64MI010712FL.pdf (last visited on September 12, 2024).

Following are different types of NPAs as provided under Clause 4.1 of the SARFAESI Act, 2002

i. Sub Standard Assets – if the asset remain as NPA for a period of less than or equal to 12 months, such asset shall be termed as Sub Standard Assets.

ii. Doubtful Assets – if the asset remains as an NPA for more than 12 months, such asset shall be termed as Doubtful Assets.

iii. Loss Assets - When an asset is deemed "uncollectable" or has such a low value that it is not recommended that it be kept as a bankable asset, it is classified as a loss asset. Nonetheless, since the asset has not been fully or partially written off, there can still be some recovery potential in it.

The banks are required to make their NPA numbers public and to the RBI from time to time. For this primarily two metrics are used to understand banks' NPA situation which can be expressed as a percentage of total advances:

i. GNPA (Gross Non-performing Assets) – "which is an absolute amount, stating the total value of GNPA for the bank in the particular quarter or financial year, as the case may be. GNPA ratios is the ratio of total GNPA of the total advances."[12]

ii. NNPA (Net Non-performing Assets) – "subtracts the provisions made by the bank from the gross NPA, thus giving the exact value of NPA after the bank has made specific provisions. NNPA ratio uses the net NPA to determine the ratio to the total advances"[13].

<u>Declaration of NPA by the Creditor</u>

The bank or financial institution advances to the next stage for the declaration of non-performing assets (NPA) after the borrower begins to fall behind on installment payments. The RBI has classified the non-performing assets (NPAs) for various loan categories provided by banks, based on the non-payment of installments for a specified length of time.

[12] *Available at* : https://groww.in/p/non-performing-assets (last visited on September 12, 2024).
[13] *Available at* : https://groww.in/p/non-performing-assets (last visited on September 12, 2024).

The RBI has categorized based on how many days have passed since the borrower's account received its previous payment on the following grounds:

i. Where interest and/or instalment of principal remain overdue for a duration of more than 90dyas in respect of a term loan,
ii. Where the account remains ‘out of order’ for a period of more than 90 days, in respect of an overdraft/cash credit (OD/CC)
iii. The bill remains overdue for a period of more than 90days in the case of bills purchased and discounted,
iv. Where interest and/or instalment of principal remains overdue for 2 harvest seasons but for a period not exceeding 2 half years in the case of an advance granted for agriculture purposes,
v. Where any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

To Whom NPA is Declared?

An NPA is reported on any property that the bank or financial institution owns. All loan accounts that meet the aforementioned requirements to be classified as non-performing will be designated as non-performing assets (NPAs). On the other hand, the borrower is obligated to reimburse the bank for the loss that the NPA caused to appear on its books.[14] Banks impose a levy on the borrower to recoup the loss through litigation or by transferring the non-performing asset (NPA) to asset reconstruction firms that are registered under the SARFAESI Act, 2002.[16]

Impact of SARFAESI Act, 2002 on NPAs

After significant changes, the Narasimha Committee-II recommendations became the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act). In order to purchase troubled secured financial assets, asset

[14] *Available at* : https://groww.in/p/non-performing-assets (last visited on September 12, 2024).
[16] *Available at* : https://blog.ipleaders.in/understanding-term-non-performing-asset-used-financialinstitutes/#Definition_of_non-performing_asset_NPA (last visited on September 12, 2024).

reconstruction firms are established and registered with the Reserve Bank of India (RBI) as reconstruction companies (RC) and securitization companies (SC).

"According to the Reserve Bank of India Report on Trend and Progress of Banking in India 201718, the overall ratio of amount recovered to the amount involved, improved drastically to 41.3 per cent against 13.8 per cent in the previous year.[15] As per provisional data for 2017-18, banks recovered 5.28 lakh crores (38,500 crores in the previous year), while the amount involved was 12, 78, 600 crores."[16]

"Under the SARFAESI route, banks recovered 26,500 crores (25,900 crores), while the amount involved stood at 1, 06,700 crores (1,41,400 crores). The ratio of the amount recovered to the amount involved in this case improved to 24.8 per cent, against 18.3 per cent in the previous year. Under the Debts Recovery Tribunal route, banks recovery declined to 7,200 crores (10,300 crores), while the amount involved stood at ₹1,33,300 crores (1,00,800 cores)."[17]

Challenges under SARFAESI ACT

By enabling banks to simplify their balance sheets and transfer the recovery responsibility to an organization capable of providing full-time attention, the SARFAESI Act helped accelerate the resolution of non-performing loans (NPAs). Banks were also able to realize a larger sum than what the borrower was ready to provide. Asset recovery corporations, or ARCs, were successful in retrieving the money at first, but it was later discovered that the offer price was considerably lower, and the assets were ultimately sold by them to the company' original founders or their family members.

The Indian Banks Association (IBA) and CBI officials expressed their opinion at a meeting called by the Central Vigilance Commission (CVC) in May 2010 that was attended by CMDs of some banks. They believed that some ARCs were directly assisting the defaulter in regaining back the properties by paying exceedingly small amounts to banks, which they would then mark up and

[15] Neha Singh, "Impact of SARFAESI on NPA," 6 *International Journal of Legal Developments and Allied Issues* 162 (2020).

[16] Greeshma Francis, "An Overview of SARFAESI Act and Its Impact on NPA," 8 *Paripex-Indian Journal Of Research* 27 (2019).

[17] Greeshma Francis, "An Overview of SARFAESI Act and Its Impact on NPA," 8 *Paripex-Indian Journal Of Research* 27 (2019).

sell back to the borrower. The banks have discovered that they get far better responses when they send notifications to debtors under the SARFAESI Act.

An enraged party, usually the borrower, can apply to a DRT and get an easily obtained stay order on sale, which is the one main issue the banks have while pursuing SARFAESI allowed action. The banks believe that SARFAESI has been a more successful application of law than other measures. The bank executives believe that rather than turning over, they can demonstrate more success by fortifying the recovery section.

Conclusion

All that is owned is considered an asset. Because the interest we pay on these loans is one of the bank's main sources of income, a loan is considered an asset by banks. The asset for the bank becomes "non-performing" when consumers, whether corporate or retail, are unable to pay the interest since the asset is not generating any revenue for the bank. NPAs, then, are assets that no longer bring in money for the RBI.

The public sector banking industry is experiencing a severe crisis due to an increase in nonperforming assets. It has an impact on the banking industry's expansion and profitability. Several steps have been taken by RBI to slow the rise of non-performing assets (NPAs) in the banking industry. It also presented a number of methods for regulating growth rates since it began to affect the nation's economic expansion. As NPA rates ascend, the borrowing system also gets pompous. Appropriate financing recoveries will only increase lending and accelerate the expansion of bank profits.

Despite being a strong weapon for financial institutions, the SARFAESI Act has drawn criticism for being onerous and discriminatory against debtors. The Act gives creditors a great deal of authority, which if abused, may result in intimidation and unjust treatment of debtors. Opponents contend that the Act unfairly favors financial companies while frequently ignoring the real struggles that borrowers experience.

For the purpose of maintaining stability and financial discipline, supporters of the Act stress the need for these authorities. They contend that by offering a methodical and open process of recovery and sufficient protections for borrowers through the appeal procedures, the Act serves to defend the interests of both creditors and debtors. Reducing non-performing assets (NPAs) and

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collecting past due payments promptly are critical to the banking industry's and the economy's general health.

For Indian financial institutions, the SARFAESI Act is still an essential piece of legislation that protects borrowers' rights while enabling effective debt collection. Although the Act has been criticized for being excessively stringent, its provisions and the interpretations of courts provide a fair and impartial method of upholding security interests. The Act is a vital instrument for the banking industry as it has greatly aided in the development of financial discipline and the decrease of non-performing assets. However, in order to prevent abuse and guarantee that borrowers' rights are sufficiently safeguarded, ongoing supervision and judicial review are crucial.