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The SARFAESI Act: A Regulatory Framework for NPAs in India

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Abstract

In India the Banking Sector dominates the financial market and has become crucial to Country's development and its economic growth. In the past few decades it has emerged as the backbone of the Country's economy mainly because, it is the banking sector that finances all the big projects in the country undertaken by the Government or big companies. However, in recent times the NPAs have become a major threat against the expansion of banking sector in the Country because they render such banks incapable of dispersing the surplus in the deficit sector. Before the enactment of the SARFAESI Act, there was literally no other option for the banks to recover their loan apart from getting help from the civil courts. But even this was a huge problem for them because of the time it may take to get a final decree. But since the enactment of the Act the banks have now become empowered to enforce the security to recover their loans. Hence, this paper primarily aims to examine the effectiveness of the recovery mechanism and certain problems in the implementation of the Act itself. Furthermore, this paper also endeavours to analyse the SARFAESI Act and the modes of recovery stipulated by it. Thereafter, concluding it with recommendations.

Keywords: *Non-performing assets, recovery, reconstruction, regulatory mechanism, secured assets*

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INTRODUCTION

As mentioned, the Banking Sector dominates the financial sector in the country. And this is mainly because the banks provide funding for the big projects requiring hefty sum of money. Insurance sectors or the Corporate Municipal Bond Markets are generally not financially capable to provide the bulk funding for big projects. Furthermore, the Public Sector Banks are the ones who prefer to provide funding for infrastructure, power and development projects. The Private Sector Banks usually don't prefer to take risks and give loans which are not generally longer than five year maturity period, except in the cases of housing loans where the property itself is the collateral.

The most basic function of a bank is to make use of the surplus savings of the depositors by putting it into the to the deficit sector in the form of credit which they can use for their growth and development thereafter returning the credited amount back with the interest. Simply put, banks act as intermediaries between the depositors and borrowers. However this whole process breaks down once the borrower fails to repay the credited amount along with the interest. Therefore, the banks often insist for assets to be secured against the loans to be granted. But still, merely holding the security could not said to be enough as, once the borrower becomes unable to pay back the loan, the bank will have to enforce the security to recover back the amount. And this was a problem in itself for the banks because the civil laws and the prevalent banking laws were not very helpful for the banks in this regard and getting a decree from the civil courts for enforcement of securities was a very long process.

After the recommendations of the Narasimham Committee it was discovered that the Indian Banks are heavily burdened with increasing amount of non-performing assets, financially impairing them. Therefore, a void for legislation was felt giving authority to the banks, enabling them to enforce the assets of the borrower which were securitised by him under a security contract against the amount credited to him, that too without the interference of Courts or Tribunals.

The Present Day Crisis

Initially this scheme was working out for the Public Sector Banks especially during the last decade. This was because the high rate of credit expansion which led to the drastic increase in the infrastructure projects and capital hungry projects requiring volumes of fund. But soon after, because of the continuous interference from the Central Government which was also the majority stakeholder, the Public Sector Banks started risky lending of money to the Public Private Partnership Projects. And soon after, because of the inflated project costs and quick disposal of assets by the defaulters, made them almost immune to the debt recovery process as there were no prominent assets left only for the banks to take under its control for recovery of dues. This is well evident from the quarterly and the annual figures of the total NPAs due to the banks. As per the CARE Ratings, in the April-June quarter (Q1) of FY18, NPAs of a sample of 38 banks increased by a sharp 34.2 per cent on a year-on-year basis and also, the NPA ratio increased to 10.21 per cent in June 2017 from 8.42 per cent in June 2018, which was the highest in the last six quarters [1]. On a quarter-on-quarter basis, the increase in NPAs has been the highest in Q1 FY18 witnessing an increase of about 16.6 per cent to reach ₹8,29,338 crore as of June 2017 [2]. And because of these high volumes of non-performing assets/non-performing loans for the Public as well as the Private Sector Banks' the lending capacity have reduced drastically.

The losses which the banks incur due to the NPAs are also because of its approach with regards to financing and recovery of loans and their attitude towards the small and medium enterprises. Furthermore, this can also be attributed to the limited knowledge of banks about the practical application of Banking laws and deviations from RBI notifications and directives. Whatever the reason might be, it does not changes the fact that a reliable and strong banking sector is sine qua non for a developing economy and the failure of which might have devastating effects upon all the sectors.

LITERATURE REVIEW

There is a continually extending assortment of writing in regards increasing burden of non-performing assets on the banks and the need to enforce these securities. The concept of securitization of assets and NPAs is not an old one criminal liability of the directors is not a very old topic and is not being faced only by the developing economies like India. It is a problem that has emerged in recent times and in various countries inspiring many researchers and scholars to probe into the causes and effects of these NPAs/NPLs. In addition to this many studies have been conducted that study the different legislations governing this and the merits and demerits of the legislation for enabling the banks to recover their loans. This has prompted the advancement of a limitless collection of work which has examined this issue from the point of view of every conceivable partner. The Researcher has endeavoured to cover the whole extent of writing accessible in considerable sum with a specific end goal to give an unbiased perspective.

One of the most comprehensive works done on the effectiveness of the SARFAESI Act regarding the recovery of due amount through enforcement of securities was done by V. Seka and Dr. V. Balachandran in their work—Implementation of SARFAESI Act [3] wherein they analysed the whole Act and found out that despite some problems in its implementation like—priority of government dues, overall the Act is quite efficient when it comes to enforcement of assets for realisation of the due amount. Before this act it was huge problem for the Banks to get a decree from the courts to exercise their right upon such assets. But since the enactment of this legislation no Court or Tribunal can interfere with this process. Furthermore, an interesting insight was presented by Sahni and Seth in their paper—Non-Performing Assets (NPAS) in Indian Commercial Banks [4], a study was conducted by them on the NPAs in the Commercial Banks and the need for them to be organized. By drawing an example from the Government and its measure to reduce the NPAs, according to them the Private Banks should also take certain steps and be careful while granting loans keeping in mind the credit worthiness of the borrower. In A Study on Non-Performing Assets [5] authored by Banana, K. & Chepuria it is discussed that how the rate of advances is decreasing and NPAs are increasing being reversely proportional to each other. Furthermore, the paper stresses on the need of supervision on the loans granted to the borrowers as well as on their assets.

A different and interesting view is presented by V R Singh in his paper—A Study of Non-Performing Assets of Commercial Banks and its Recovery in India [6] wherein he emphasized upon the role of the Government to take measures so as to reduce the burden of NPAs on Private Sector Banks. Although the author agrees with the fact that SARFAESI Act has somehow helped the banks in overcoming the overdue debts, but still stresses on the fact that certain other steps can also be taken to deal with this problem more effectively. Furthermore, in Banking Sector Reforms and NPA [7] by Rajeev, M. and Mahesh, H.P. the effectiveness of SARFAESI Act was highlighted in comparison with the RDDBI Act. The paper discusses the recovery process focusing on the DRTs and DRATs and the workload upon them.

RESEARCH METHODOLOGY

Since, the topic of this research exceptionally covers a very vast area and is of extreme significance therefore the Researcher has mainly focused on the secondary sources of data and information for example Data from Reserve Bank of India, various trend reports, etc. The Researcher has primarily relied on the articles, books, journals and other works by several authors, Indian and foreign, whose works have contributed significantly in development of jurisprudence on criminal liability of the directors. Apart from these, the other primary sources will be the cases and arbitral awards which the Researcher will consider to understand the judicial view on the constitutionality of the SARFAESI Act.

OBJECTIVES OF THE STUDY AND RESEARCH GAP

After analysing the literature regarding the NPAs and regulatory mechanism including journals, online articles, books, several blogs and even data from RBI, it is quite evident that although a lot of studies has been conducted on non-performing assets, its effects on the Banking Sector, its causes and even its management. But till date only a few studies talk about the recovery process stipulated in the SARFAESI Act and the overall efficiency of it in dealing with the increasing load of NPAs. Furthermore, not many authors have discussed the implementation of the SARFAESI Act. Hence, this paper endeavours to exploit the abovementioned gap and bring forth an analysis dealing with this aspect. Therefore, this paper aims to

- To discuss the concept of non-performing assets along with the classification of assets for the purpose of securitization.
- To study the efficiency of SARFAESI Act for recovering debts of Scheduled Commercial Banks.
- To analyse the issues in implementation of SARFAESI Act.

HYPOTHESIS

For the purposes of this paper the Researcher has adopted the following hypothesis:

The banking sector plays a pivotal role in the financial market as it contributes to the GDP of the country by financing development schemes and investing in big projects. But despite this fact, the increasing load of NPAs in this sector has become a great challenge for them and therefore recovery of dues from such entities has become crucial for the Scheduled Banks. Hence, an attempt is made via this paper so as to adjudge the recovery framework functional for this purpose.

SCOPE AND FURTHER RESEARCH

The topic of this research exceptionally covers a very vast area and is of extreme significance and the Researcher trusts that it will incite more Indian academicians to research on this matter as it can be also taken as different aspect of education and ethical business practices.

THE CRITICAL ANALYSIS

The Concept of Non-performing Assets

As per Section 13 of the SARFAESI Act if a borrower who is under any kind of liability to a secured creditor as per a security agreement and thereby makes any default in the payment of the principal amount or even the interest thereof, then such secured creditor can declare that account with respect to the debt, as a non performing account. In simple language if the borrower is unable to pay the principal amount that was credited to him along with the interest within 90 days, then that asset becomes a non-performing asset.

Furthermore, as per the norms of Reserve Bank of India for classification of assets, they can be classified into the following four types of bank assets:

- Standard Assets
- Substandard Assets
- Doubtful Assets
- Loss Assets

Standard Assets

Standard Assets are those assets wherein there is hardly any chance of default from the borrower's side although it carries a nominal risk along with it. Such assets are not to be considered as non-performing assets and the provision for such assets have been set at 0.25% of all kind of standard advances.

Substandard Assets

Sub-standard Assets are those assets that remain as non-performing assets for a period of up to 12 months at least and provision for such assets have been set at 10% of all kind of standard advances.

Doubtful Assets

An asset that remains to be a non-performing asset for a term of more than 12 months would be declared as Doubtful Asset. The provisions for such assets are different from the others and are as follows:

- For a term up to 1 year provision, it is 100% of no secured advances and 20% of secured advances
- For a term more than 1 year, but less than 3 years provision is made 100% of unsecured advances and 30% of secured advances
- For a term of 3 years or more provision is made 100% of both unsecured and secured advances.

Loss Assets

An asset which remains as non-performing asset for a period of more than 3 years is termed as Loss Asset. Provision for such kind of assets is made to be 100% of unsecured and 100% of secured advances.

NPAs Recovered Through Various Channels of Scheduled Commercial Banks

NPAs Recovered through Lok Adalats

NPA recovery through Lok Adalats is one of the channels opted by the Scheduled Commercial Banks. As per the data retrieved from the website of Reserve Bank of India, the cases that have been referred to Lok Adalats for recovery have increased quite gradually in the 2017–2018 since 2007–2008. Although the statistics regarding the recovery from non-performing assets are showing an inconsistent trend till year 2015–2018 since 2007–2008. Although the cases that are coming for recovery from NPAs to Lok Adalats have increased, however, the percentage of recovery is not so gradual. For instance the total amount that the banks were able to recover in 2018 through Lok Adalats was 3200 Cr. out of 72000Cr [8] which is just 4.4% of the total amount to be recovered. And due to the inefficiency in recovering the due amount, the banks often refer to other channels for recovery.

NPAs Recovered Through Debt Recovery Tribunals

Since the banks are not able to recover much through the channel of Lok Adalats, they often opt for other channels for recovery and recovery through Debt Recovery Tribunal is one of them. As per the statistics provided on the site of Reserve Bank of India, the banks were able to recover almost 81.1% of the amount due from the non-performing assets in the year 2008–2009 and thereafter these stats have remained somewhat uniform [9]. Hence, it is quite evident that DRTs are much more efficient that Lok Adalats in recovery of the amount from NPAs. This may also be due to the fact that DRTs have been given certain powers and authority which when violated can attract certain punishment or penalty. And this has led to create some form of deterrence for the borrowers. However Lok Adalat has no such power except for the fact that their decisions are binding and are of final nature.

NPAs Recovered through SARFAESI Act 2002

As per the figure provided on the RBI's website the number of cases that were referred under the SARFAESI Act was 83,942 Cr. in the year 2008 and increased to 1,73,582 Cr [10] in the year 2018. Furthermore, the total amount involved in the cases filed under the SARFAESI Act increased from 7263Cr. to 80100Cr. between the periods 2008–2018 [11]. These figures are indicative of the fact that secured creditors have now started to adopt different modes for recovery from NPAs which as result would decrease the load of NPAs on the Banking Sector.

NPAs of SCBs Recovered through Various Channels

The overall figure depicts that the recovery percentage from NPAs by Lok Adalat (8.2%) is minimal when compared to the recovery percentage from NPA recovery by DRTs which is 51.9% and SARFAESI Act 2002 which is 61%. Then again in the year 2018 the percentage of NPA recovered from the Lok Adalat decreased to 4.4% in Lok Adalat but the recovery percentages of DRTs and under the SARFAESI Act remained the same. Therefore after the due analysis of recovery from NPAs via all the channels it can be easily concluded that recoveries made under the SARFAESI Act is the most efficient.

The SARFAESI Act, 2002

The Securitization and Reconstruction of Financial Assets and Enforcement of Security interest Act came into force with effect from 17th of December, 2002. The Act was first introduced as an ordinance and thereafter was passed eventually by both of the Houses in Parliament. The importance of this legislation is that it enables the secured creditors to take possession of the assets of the borrower that were secured by him under a security contract, in case the borrower fails to pay the principal amount along with the interest within a period of 90 days. This Act is also important because as per the provisions the secured creditor can proceed with the assets of the defaulter without any interference from Tribunals or Courts. Also, it would be noteworthy to mention that this Act is also relevant in the present economic scenario because it enables and facilitates mobility of money especially for the purpose of development programmes. Prior to the enactment of this legislation, the secured creditors were not able to recover the money from the hands of NPAs due to which it became very difficult for the lending bankers to finance other projects, resulting in loss to economy and financial sector. However, with the enactment of this Act, this problem was done away with.

Despite being a groundbreaking legislation in terms of recovery of credited amount from the defaulters it had certain shortcomings. Hence, the constitutionality of this case was challenged before the Hon'ble Supreme Court on the basis of those shortcomings only in the case of *Mardia Chemicals v Union of India* [12]. But the Hon'ble Supreme Court held the Act to be non-violative of the Constitution although certain modifications were suggested to be made to the Act in consonance with the principle of Equity and Natural Justice.

Presently, the Act lays down four prerequisites enshrined in Section 13 of the said Act, which are to be satisfied in order to enforce the right of the secured creditor:

1. The debt or the sum that has been credited must be secured under a security contract.
2. The borrower has defaulted in paying the principal amount or the instalments thereof, and has been declared as a non-performing asset.
3. The borrower has defaulted for payment of Rs.1 Lakh or above and more than twenty percent of the principal loan amount along with the interest thereon.
4. The last condition is that the secured creditor cannot proceed against the defaulter's assets if it is an agricultural land.

Methods of Recovery under the SARFAESI Act

The SARFAESI Act consists of provisions regarding registration and regulation of securitization and asset reconstruction companies and mechanisms for recovery from Non-performing Assets. These mechanisms or methods can be summarised as below:

- Banks' financial assets can be securitized under this Act making them financially independent.

- Under this Act the Securitization Companies and Asset Reconstruction Companies are empowered to raise funds via Qualified Institutional Buyers.
- Most importantly because of this Act the banks are now empowered to enforce the securities of defaulters for recovering the due amount and can even sell, lease or take under possession the same in case of further default.

The SARFAESI Act further provides for three additional methods for recovery of Non-performing Assets—Securitization, Asset Reconstruction and Exemption from Registration of Security receipt.

Shortcomings of the SARFAESI Act

Although SARFAESI Act has proved to be highly effective and efficient in case of recovery of NPAs but however there are still some shortcomings that are to be dealt with. These are:

- Although a securitization receipt gives its holder a right of title or interest over the assets of financial nature included in the process of securitization. But the definition used is not legally accurate when it comes to Pay through Securities in cases of different tranches.
- The SARFAESI Act does not consider the Non-Banking Financial Institutions or other similar bodies unless it is notified by the Central Government to be a financial institution.
- The Act also does not account for several risks involved in securitization for instance—Credit Risk, Sovereign Risk, Collateral deterioration Risk, Legal Risk and Financial Guarantor Risk.
- Although SARFAESI Act has overriding effect on other laws, however the claim of government will be given priority since usually the amount recovered via sale is claimed back by the authorities.
- It is very often that High Courts interfere in the SARFAESI Act recoveries by proceeding Writs filed by the defaulters. Although the Supreme Court has held in plethora of cases that one can approach the Supreme Court only after exhausting all the alternate remedies. However, writ petitions can be filed once it is alleged that fundamental rights have been violated. The SARFAESI Act provides for Debt Recovery Tribunal and Debt Recovery Appellate Tribunal for the disputes arising out of recovery process, but it is often disregarded by the defaulters so as to cause delay in the recovery process.

RECOMMENDATIONS

After the detailed analysis regarding the concept of Non-Performing Entities, the recovery process from such non-performing assets, their effects on the banking system and the overall efficiency of the SARFAESI Act, the author would like to put forth the following recommendations.

- As discussed above, among all the recovery channels, the recoveries from the Lok Adalats were minimal; therefore, more awareness has to be created about this channel so that the workload on other channels can reduce.
- The reason for the increasing load of NPAs on Banks is their attitude towards the small scale and medium scale business and defective lending process, therefore RBI should come up with notifications for these Banks, to adopt a stringent recovery mechanism.
- Another reason for increase in NPAs is the willful default by the defaulters and lack of deterrence among them. To counter this, the Banks can take action against them through electronic media and newspaper by publishing their names so as to coerce them to pay up the amount due as soon as possible.
- Amendments must be brought to the SARFAESI Act so as make it more bank friendly along with making it more serious for habitual defaulters.

CONCLUSION

The primary function of a Bank is to disperse the surplus deposit that it is getting from the depositors, deficit sector to finance projects and business. Furthermore, the main source of revenue for banks is the interest on the loans that they give to the borrowers. However, this source of revenue collapses as soon as a borrower makes default in paying back the principal amount along with the interest and after being declared as a non-performing asset. That is the reason why the money that is blocked as NPAs has a devastating effect on a bank's capability to provide finance for other projects.

As per the analysis, the Public Sector Banks are the one suffering from huge load of non-performing assets. This is mainly because of the pressure that it gets from the Government to finance big projects which often take time to get complete. In addition to this often borrowers dispose of the assets that they provide for securitization under a security contract. Although the Government is taking some measures to deal with the problem of increasing load of NPAs, but still a lot has to be done on certain different levels so as to get a positive result in this aspect.

According to the analysis, it is pretty evident that out of all the channels for recovery from NPAS, the SARFAESI Act has proved to be much more effective and can be viewed as the most effective measure taken up by the Government for the Banking sector to deal with the problem of recovery of NPAs. But then it has to be made much more effective so as to match up with the pace of increasing number of cases of NPAs in the Banking sector. Otherwise the whole mechanism might fall on its face.

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