



THE SECURITIZATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTEREST ACT (SARFAESI), 2002: A CRITICAL STUDY

NADEEM HASAN MALEK

Research Scholar, Gujarat National Law University, Gandhinagar (Gujarat), India

Abstract

Increasing non-performing assets (NPAs) of the banks have posed several severe challenges in maintaining the economic stability of any country and India is no exception to this. With the objective of reducing NPAs of the nation and thereby having economic stability in the country, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) was enacted in 2002 in India. The primary intent of the SARFAESI Act aims to set guidelines of securitization and reconstruction of financial assets and enforcement of security interests. This research paper attempts to critically study the SARFAESI Act, 2002 that was legislated in 2002 and critically look into the shortcomings that are encountered in the execution of the Act.

Keywords: SARFAESI Act 2002, Debt Recovery Tribunals, Non-performing assets (NPA), Securitization and Assets Reconstruction, Secured Creditors, Borrowers

INTRODUCTION

It is a manifested truth that all across the world; the banking sector plays a significant role in the advancement of the economy of the nation. The financial stability of the nation largely depends upon its banking sector. This sector provides funds for several developmental projects that in turn leads towards the development and progress of the nation. The fundamental duty of a bank is to make use of the depositors' surplus funds by lending them to the deficit sector as credit, which they can use to expand and develop, and then returning the credited amount with interest. Thus, the banks play a vital role in acting as an intermediate between the ones who need money and the depositors. However, the problem for the banking sector arises when the borrowers fail to repay the loans that they have borrowed from the



banks and other financial institutions of the country. Even though the banks and financial institutions have security assets, it takes longer time for them to recover the security assets as the banks have to get a decree from the civil court for the enforcement of the securities. This civil law procedure takes a longer duration of time and therefore creates a delay in the recovery of the security assets. As per the reports by Narasimham Committee, the Banks in India are under extreme pressure of the increasing amount of non-performing Assets (NPAs). This increasing NPAs act as a burden on the Indian banks and financially weaken them further damaging the credibility of the bank in the banking sector. Thus, it was realized by the government that the banking sector needed a legislation that could give authority to the bank for the securitization of the assets of the borrower without much interferences from the courts. Hence the SARFAESI Act, 2002 came into effect in the year 2002 with the intension to strengthen the banking system against the increasing NPAs.

RESEARCH METHODOLOGY

The topic of the present research paper deals with the critical understanding of the „Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002“that is related to the area of banking sector. The present paper aims to study the secondary sources of the data that are available through several reports and data from RBI. Apart from this, books, journals, articles, reports and statistical data have been referred to have a critical understanding of the SARFAESI Act, 2002.

OBJECTIVES OF THE STUDY

After the thorough understanding of the literature related to the increasing NPAs of the banks in India, it is evident that substantial research is done on the non-performing assets and the consequences of this increasing NPAs on the bank and the development of the nation at large. However, it is observed that only a few studies have focused on the SARFAESI Act, 2002 and its recovery process and how efficient it is in reducing the NPAs of the banking sector. Therefore, this paper aims to critically study the SARFAESI Act, its implementation and the key challenges in the implementation of the Act.



Non- Performing Assets (NPAs)

As defined under the section 13 of the SARFAESI Act, 2002, when a borrower under any type of liability makes a default in the payment of the amount borrowed, then the creditor can put the account under the non-performing asset. Being more specific, when the borrower fails to pay the principal amount along with the interest to the creditor bank within the stipulated period of ninety days than the asset is labelled as non-performing asset (NPA). The non-performing assets of the banks or any other financial institutions are further classified into standard assets, substandard assets, loss assets and doubtful assets. These assets are classified according to the norms and regulations of RBI.

The „standard assets“ are defined as assets that have very less chances of default by the borrower and therefore the risk involved in it is very minimal. Whereas, in substandard assets the assets remain non-performing assets for a period of minimum twelve months. The doubtful assets are those assets that that are labelled as non-performing assets for an interval of more than twelve months and the loss assets remain as non-performing for a time period of more than three years.

There are several channels through which the NPAs can be recovered. A study of the NPAs recovered through Lok Adalats has revealed that the cases of NAP recovery that had been referred to LokAdalats had witnessed a significant rise in the year 2017-18. However, it is also revealed that though the numbers of cases referred to the Lok Adalats have increased since the years but the rate of recovery of the NPAs through LokAdalats in terms of percentage is less. “The total amount that the banks were able to recover in 2018 through LokAdalats was 3200 Cr. out of 72000Cr 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.” (p: 32)¹. Since the banks in India were unable to recover through the LokAdalats, they selected other channels of recovery and one among them is the recovery through the debt recovery tribunals. Gautam (2018) states, that as per the statistics given by Reserve Bank of India, banks in India

¹DivyanshGautam. The SARFAESI Act: A Regulatory Framework for NPAs in India. *Journal of Capital Market and Securities Law*. 2018; 1(1): 29–35p



were able to do the recovery of 81.1% amount in the year 2008-2009. And this made it evident that the debt recovery tribunals were much successful in the recovery of amount through NPAs as compared to the Lok Adalats.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI), 2002: A Critical Study

With the objective of enabling the secured creditors to take over the assets of the borrowers in case they fail to repay the borrowed amount with interest within 90 days, the SARFAESI Act, 2002, came into effect from 17th December, 2002. Thus, the SARFAESI Act became an important Act that enabled the creditors to take the possession of the security assets from the borrowers without the intervention and stays from tribunals and courts. The SARFAESI Act and its implementation proved to be very crucial as the banks and financial institutions could lessen the burden of NPAs. Prior to the implementation of the SARFAESI Act, the secured creditors were unable to get the recovery of the money from the borrowers and this in turn led to increasing NPAs that largely affected the credibility of the banking and financial institutions in the financial sector. Further, as a result of increasing NPAs, the banks were unable to fund the developmental projects contributing to the progress of the nation. As a result, this led to the loss of economy. Therefore, the SARFAESI Act helped the secured creditors to get the recovery of secured assets without much delay.

The SARFAESI Act, 2002, gives authority to the bank and other financial institutions to seize the property in case the borrower defaults the payment. For this, the bank or any other financial institutions where the borrower has defaulted the payment, gives the notice to the borrowers to discharge their liabilities in the time period of sixty days. And when the defaulting borrower fails to comply with this notice, the bank can take the recourse under the SARFAESI Act for enforcement of security assets. The bank can take the possession of the secured asset. It can lease, sell or assign the right of the security and also manage the same by appointing a person.² Thus, the SARFAESI Act 2002, was

² SARFAESI ACT, 2002- Applicability, Objectives, Process, Documentation (2022). <https://cleartax.in/s/sarfaesi-act>



formed in order to regulate securitization and reconstruction of financial assets, enforcement of the security interest and matters that are connected or incidental thereto. As per Panigrahi and Chaudhury, the formation and implementation of the SARFAESI Act 2002, has proved to be a benchmark that has reformed the banking sector of the nation. And, this is evident by the fact that in 2002-2003, when the act was implemented, there was a reduction of non-performing loans from 14% in 1999-00 to 9.4% and further 3.8% in the year 2016. Thus, the formation and implementation of the SARFAESI Act has significantly helped the creditors to recovery the overdue amounts labelled under the non-performing assets. The SARFAESI Act, 2002 has also helped in contributing to reducing the NPAs of the bank of the nation and thereby has given stability to the banking sector to stand the test of the time in case of NPAs.³

Prerequisites for proceeding under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

The secured creditors can get their rights enforced under the condition that the borrower has defaulted the payment of one lakh or above one lakh. Additionally, the amount can be more than twenty percent of the principal loan amount including interest. Secondly, the borrower should have defaulted in paying the principal amount that is loaned or the instalments. Thirdly, the sum that is credited or the amount of debt should be secured under a security contract. And lastly, for the secured creditor to proceed against the defaulter it is necessary that the asset that is secured should not be an agricultural land.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002: Methods of Recovery

The SARFAESI Act has set provisions for the regulation and the registrations of the Act. These are stated as under:

[2002#:~:text=The%20SARFAESI%20Act%20allows%20banks,through%20recovery%20methods%20and%20reconstruction.](#)

³Panigrahi, M. A., &Chaudhury, S. K. (2017), The Impact of SARFAESI Act 2002 In Reducing Non-Performing Assets of Indian Scheduled Commercial Banks. p. 126



- By making the banks financial assets independent, the assets can be securitized.
- Under the SARFAESI Act 2002, the banks get the authority to confiscate the property of the defaulting borrowers by issuing notice to the defaulters. Under the process securitization of the assets, the marketable securities are issued that are maintained by a pool of existing assets. The assets are transformed to the marketable security after they are sold to the investors. According to the RBI regulations for Assets reconstruction, the ARC initiate to purchase bad assets, debentures, securities and bond. These assets reconstructions are carried out through the ways of taking over its business, borrower's business systematic managements and even rescheduling the debt payment of the borrower or selling the business in parts or whole.
- The notice has to be issued to the borrower to discharge his/her liabilities within sixty days. And in cases if the borrowers are not able to comply to the instructions stated in the notice, the financial institutions and banks are permitted to take charge of the secured assets for the loan. The banks later are given the charge to lease or sell the property or the assets.
- The formation of Asset Reconstruction Companies (ARCs) can be done under the regulations of the RBI. These ARCs help in acquiring the assets from the banks and financial intuitions. For the sale of assets to the Asset Reconstruction Companies, the banks have to obey the guidelines and regulations issued by Reserve Bank of India regarding the enforcement of selling the assets to the ARCs.
- Along with the objective of strengthening the banking system in India, the SARFAESI Act, 2002, equally protects the rights of the borrowers. The act allows borrowers to remit the dues before the sale of security assets takes place. In this way the borrowers can avoid losing their security assets. Additionally, the borrowers have the right of going to the Debt Recovery Tribunal in case they have grievances related to the matters. If the banking officials are found doing wrongful or illegal act that can lead to injustice towards borrowers, they havego through the penal consequences. Thus, in the formation and implementation of the SARFAESI Act 2002, it is ensured that the rights of both the banks and the borrower are protected.



- This act enables the securitization and assets reconstruction companies to raise the fund through intuitional buyers that are qualified.
- Securitization, Asset reconstruction and exemption from registration of security receipt are the additional mechanism for the recovery of NPAs.

Implementation of theSecuritization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002: Shortcomings

Even though SARFAESI Act was introduced to reduce the burden of NPAs on the banks in India, there are few shortcomings in the implementation of the act.

- The SARFAESI Act does not include the non-banking financial institutions unless they are notified by the central government.
- In few cases the intervention by the Supreme Court in allowing the proceeding of writs to be filed by defaulters creates a lot of delay.
- The Act does not take into account the other risk involved in securitization of the assets like legal risk, guarantor risk, credit risk and collateral deterioration risk.
- It is experienced that under the implementation and enforcement of this Act, the borrowers complain that have to face problems because of banking executives and their behaviour. Even though there exists the possibility of regularizing the loan account, the banks mark the accounts as non-performing assets. With reference to the NPAs, in rare cases, banks fail to keep in steps by the guiding principle that are presented by RBI regarding the implementation of the SARFAESI Act, 2002.
- Courts in India often have to interfere in the implementation of the SARFAESI Act when they get writs that are filled by the aggrieved parties. These writs that are filled by the aggrieved party often cause a delay in the process of recovery.
- In many cases, the Asset Reconstruction Companies (ARCs) are given the charge to recovering the non-performing assets when the defaulters default the repayment of the amount borrowed. In this case, sometimes it is observed that those Asset Reconstruction Companies who are given the charge of recovering the non-performing assets have the tendency to sell the assets to company"s promoters or



to those people with whom they are associated. In few cases, it is also observed that the Asset Reconstruction Companies (ARCs) aid the defaulters in reacquiring their assets or properties simply by disbursing very less amount to the financial institutions and banks and subsequently sell back the assets or properties to the borrowers⁴.

- The postponement in the process of the recovery of dues takes place when DRTs orders for the suspension of the measures taken by secured creditors in enforcing the security interest.
- It is also felt, the provisions of the Act are sometimes misused against smaller borrowers or against those borrowers who are unaware about the provisions of the Act and are without legal resources. Additionally, many experts have argued that provisos of the SARFAESI Act might intrude upon the principle of natural justice when the borrowers are not given a fair chance to be heard.
- The provisions of the SARFAESI Act, 2002 is not applicable to the agricultural land. In cases, challenge is faced when primary secured asset is a property land.

The SARFAESI Act, 2002 is considered to be a vital legislative step ahead to accelerate the recovery process of the non-performing assets that is considered to a barrier in maintaining the financial stability of the financial institutions and the banks in India. Considering the shortcomings witnessed in the implementation of the Act, several recommendations have been made by experts and stakeholder to enhance the effectiveness of the Act.

Recommendations

The critical study of the SARFAESI Act, 2002, has steered to coming up with recommendations that could make the implementation of the Act more effective and smooth. The committee formed by the RBI that is headed by Sudarshan Sen, former executive director of Central Bank opined that the scope of the SARFAESI Act (2002), section 5 needs to be expanded in order to allow the ARCs to procure the financial assets from regulated bodies. The ARCs also play a significant role in the

⁴Francis, G. (2019). An Overview of SARFAESI Act And Its Impact On Npa. Indian Journal Of Research 8 (4). 27-28



implementation of the Act and therefore the RBI panel has also suggested few suggestions for streamlining the functioning of the Asset Reconstruction Companies (ARCs). These include formation of the wired or virtual platform for the selling the assets and allowing the ARCs to act as a resolution applicant at the time of liquidation process. According the report released by panel of RBI, it was stated that according to the data, the performance of the ARCs has lacked effectiveness and vitality. The RBI panel also suggested that those account having above Rs 500 crore there should be two approved external bank representatives for determining the liquidation value as per the market. Whereas, for the amount between hundred crore and five hundred crore, one representative for the liquidation valuation. Furthermore, since the reserve price plays a substantial role insafeguarding the exact price in the public sale of the stressed assets, during the final sanction, the reserve price should be given by the high level committee that has been given the power to sanction to write off of the loan. According to the suggestions in the report, in order to provide a glide path, the minimum fund requirement to be held for the ARCs should be mounted to Rs two crore. Furthermore, The Central Board of Direct Taxes (CBDT) should look into the issues related to taxation of income that is generated through the investments in security receipts that are issued by ARCs. It was also suggested by the committee that ARCs should be permitted to sponsor a SEBI registered AIF that can used as an additional vehicle for facilitating the recovery and restricting of the debt acquired by the ARC. Yet another recommendation is that there should be a clear mechanism that could make distinction between the borrowers who have defaulted due to genuine hardship and those who default intentionally. Additionally, the process of the auction should be made more transparent in order to avoid undervaluation of the assets and ensure best possible valuation of the asset that is to be auctioned. Using digital technology for the purpose of sending notifications, auctions and other related process could make the process of enforcement more quick and transparent. Lastly, awareness programme should be conducted for the public, more particularly for the borrowers so that they are well informed about their rights and remedies provided to them under the provisions of the SARFAESI Act, 2002.




Conclusion

The SARFAESI Act, 2002, implemented in the Indian financial landscape have significantly contributed in bringing a paradigm shift in the recovery process of NPAs. Through the Act, an intensive mechanism is provided to the financial institutions and banks for the recovering their dues in an effective way without the intrusion of the courts. The implementation of the SARFAESI Act, 2002 in India has helped in strengthening the financial health of the banks and financial institution and has inculcated a sense of credit discipline in the nation. The implementation of the Act has raised many questions and concerns and therefore continuous discussions have been taking place regarding safeguarding borrowers' rights, potential misuse of the proviso of the Act by the FIs and banking intuitions, transparency and fairness in asset auctions etc. However, the provisions of the SARFAESI Act, 2002 have vividly highlighted the inevitability of balancing the rights of the creditors and the borrowers. The continuous monitoring of the implementations of the Act, periodic reviews based on feedback from stakeholders have led to bring about several amendments in the provisions of the SARFAESI Act so that there is no scope of injustice either to creditors or the borrowers. Thus, the SARFAESI Act, 2002 has proved to be an effective mechanism that has strengthened the banking and the financial sector.

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