1.1 History of Banking Industry

The banking sector in the India plays an important role in the growth of an economy. Through its intermediary activities, the banking sector fosters the production, distribution, exchange and consumption processes in the economic system. It stimulates the flow of funds in the economy and fuels economic growth. The efficiency of the banking system, thus determines the pace of development of the economy. Similar to any other business enterprise, the efficiency of a bank is evaluated based on profitability and quality of assets it possesses. But unlike other commercial ventures, Indian banking has social commitments integrated into its operations.

The banking system in India has had to achieve the goals of equitable income distribution, balanced regional economic growth and the reduction and elimination of private sector monopolies in trade and industry. In the post-independence period, the banking sector has played an important role in supporting the government to achieve its objectives through deposit mobilization, mass branch networking, priority sector lending and employment generation etc. Achieving such societal objectives resulted in imposing extensive regulations by the government, which in turn hampered the productivity of Indian banking during the pre-liberalization era. An evaluation of the Indian banking industry during the pre-liberalization era revealed the presence of several shortcomings which crept into the financial system over the years’ notably reduced productivity, deteriorated Asset quality and efficiency and increased the cost structure due to the backwardness of the technologies. Among these deficiencies, policy makers identified the erosion of asset quality as the most significant obstacle for the development of a sound and efficient banking sector.
BRIEF HISTORY AND DEVELOPMENT OF BANKING SYSTEM IN INDIA

Figure 1.1 Phases of Evolution of the Banking Industry

In the introduction of this strategic industry spanning over two centuries, developments have been made in terms of the regulations governing it, the ownership structure, products,
services offered and the technology deployed. Figure 1.1 shows the entire evolution can be classified into four distinct periods.

- Period I- Pre-nationalization (prior to 1955)
- Period II- Era of Nationalization and Consolidation (1955-1990)
- Period IV- Period of Increased Liberalization (2004 onwards)

The history of modern Indian banking goes back to 1683 when the first Indian Bank was established on western lines in Madras. The beginning of the modern banking era in India started with the establishment of the Bank of Calcutta in 1806. Two more Presidential Banks, namely, Bank of Bombay and Bank of Madras were set up in 1840 and 1843 respectively. With the launch of the Swadeshi movement in 1905, there were outbursts of banking activities. Many banks like Bank of Burma (1904), Bank of India (1906), Canara Bank (1906),

Bank of Rangoon (1906), Indian Bank (1906), Bank of Baroda (1908) and Central Bank (1911) had their operation with a paid up capital of Rupees Five lakhs and above. The Indian banking system had developed considerably since 1935. The Reserve Bank of India has started its operation in 1935. A critical review of the growth of banking in India in the pre independence period highlighted that the banking system had no definite shape and policy until the creation of RBI in 1935. With enactment of the Banking Regulation Act in 1949, many changes come in the structurally, geographically and functionally. In 1955, the RBI acquired control over the management and functioning of the Imperial Bank of India, which was renamed as State Bank of India (SBI). In the year 1959, the SBI merger 8 private sector banks. It was in 1960, when RBI was empowered to force compulsory mergers of weak banks with the strong ones. The move significantly reduced the total number of banks from 566 in 1951 to 85 in 1969. Up to 1990’s, this psychology prevailed as may be observed from various policies and developments in Indian banking. The Indian financial divided into different types of financial institutions, classified into banking and non-banking institutions. The banking institutions comprise of; Commercial Banks, Industrial or Investment Banks and Rural Banks. There are two types of the commercial banking system consists of ‘Nonscheduled banks’ and ‘Scheduled banks’. Nonscheduled banks are that type of the banks that are not included in the Second Schedule of the Banking Regulation Act and, thus, do not satisfy the conditions laid down by that schedule.
Scheduled banks divided into two parts scheduled commercial banks and scheduled cooperative banks. The former are further divided into four categories: (1) Public Sector Banks (which are further classified as Nationalized Banks and State Bank of India (SBI) & Associate banks); (2) Private Sector Banks (which are further classified as Old Private Sector Banks and New Private Sector Banks that emerged after 1991; (3) Foreign Banks in India; and (4) Regional Rural Banks (which operate in rural areas to provide credit and other facilities to small and marginal farmers, agricultural workers and small entrepreneurs). All the scheduled commercial banks with the exception of the foreign banks are registered in India under the Companies Act.

- The figure no. 1.2 shows the structure of scheduled banks in India.

**Figure 1.2 Structure of the Organised Banking Industry**

The financial system in India comprises of Commercial Banks including Public Sector, Private Sector and Foreign Banks, Co-operative Banks, Development Finance Institutions (DFIs) and various other institutions in the areas of Insurance, Mutual Funds and Government
Securities. Commercial Banks are playing a very important role in the financial system and payment systems. Banks are 'special' as financial intermediaries critical for mobilizing public saving and for deploying them to provide safety and return to savers. The deployment of funds mobilized through deposits involves Banks in financing economic activity and providing a lifeline for the payment system. The introduction of economic reforms gives greater flexibility and autonomy to banks in increasing their profitability, productivity and efficiency. The RBI is the central bank of the India which is the Monetary Authority of the country.

1.2 Banking Sector reforms since 1991

The main objective of the banking sector reforms in the year 1991 was to increase the profitability and efficiency of the public sector banks that controlled about 90% of the deposits, assets and credit. There were initiated in the middle of ‘current account’ crisis that occurred in early 1991. The crisis was occurring due to poor macro economic performance characterized by a public deficit of 10% and current account deficit of 3% of GDP, inflation rate of 10% and growing domestic and foreign debt. The crisis was occurring due to a temporary rise in oil price following the Iraqi invasion of Kuwait in 1990. The reforms contributed faster in the 1990s than in the 1980s as evidenced by an increase in M2 and deposits as a share of GDP. In fact, the main focus given to the banking sector under liberalization, since the Indian financial system is mainly bank based financial system and its dominant role as a resource mobilizes financial intermediary in the market.

A major component of financial liberalization initiatives is banking sector reforms. The need for a healthy, vibrant, stable and viable banking system to support the economic growth of the country has been engaging the attention for quite some time. The globalization plays key role in banks to facilitators of smooth and efficient integration of global financial markets. The financial sector reforms came with the submission of three influential reports by Chakravarthy Committee in 1985, the Vaghul in 1987 and the Narasimham Committee in 1991. The main among them was the Narasimham Committee (in 1991 and 1998 respectively).

The measures taken under this committee was (1) decrease in the percent of CRR and SLR (2) change in interest rate and entry deregulation, (3) reform related to priority sector lending, (4) deregulation for entry and branch, (5) restructuring of public sector banks. The impact of liberalization on Indian banking brought in remarkable benefits for the banking sector.
as a whole, notably the public sector banks. The changes were manifested in improved efficiency and competitiveness.

The high fiscal deficit, poor infrastructure facilities, sticky legal system, cutting of exposure to emerging markets by financial institutions is the reasons which affected Indian economy. Further, international rating agencies like standard and poor have lowered India's credit rating to sub- investment grade such negative aspects often outweigh positives such as an increasing forex reserve and manageable inflation rate.

Under such situation, it goes without saying that Banks are going into the heat of the global downturn. One would be surprised to know that Banks and face the heat of the global downturn. One would be surprised to know that Banks and financial institution in India hold Non- Performing assets worth Rs. 110000 crore. Bankers have realized that unless the level of NPA's is reduced drastically, they will find it too difficult to survive.

1.3 NPAs and Indian Banking Sector

The health of an economy largely depends upon a healthy Banking system, which in turn depends upon a sound asset structure. The Bank has created Non- Performing Assets (NPA's), when the amount of bad and doubtful Assets increased in the banks. When the amount of the loan is due, they neither recover the capital nor earn income in real terms. Such NPA’s affects the performance and profitability of the bank. This leads to drain on the social resources.

There is large contribution made by the Public Sector Banks (PSB’s) in Indian economy, such as agriculture, various industries, trade and employment and infrastructure. The ever increasing trends in deposits and credits affect the performance of Indian Banks. The public sector banks have high command in the economy due to Rs. 968749 crore as deposits and over Rs. 480681 crore as loans. However, during the last one decade or so the level of NPAs decreased in the public sector Banks. NPA has not only affected the efficiency and the profitability of the Banks, but also the overall performance e of the banks. Borrowers are not bounded to repay what he took away from the Bank loan. So, the NPA increased in the alarming level due to the willful defaulting on the part of the borrowers. The asset quality is a main parameter to assess the performance and overall functioning of banks. The reduction in asset quality results increased the level of standard Assets.

The intermediation process is the principal function of a commercial bank. Since it involves counterparty risk; risk is inherent in banking. A banker should expect that all loan
portfolios’ will not fetch returns/earned in the normal course. The loans/advances are an important source of income for the banks. The strength and soundness of the banking system primarily depend on the quality and performance of the loan portfolio, i.e. The fulfillment of obligations by borrowers promptly. The banking sector reforms in India during the post-liberalization period, mostly focused on improving the efficiency of the banking sector by incorporating prudential norms for income recognition, asset classification and provisioning and through integrating international standards. The alarming level of NPAs is recognized as one of the major explanations for implementing structural changes and reform measures in the banking sector during this period. So in the light of inefficiencies in the banking sector and the presence of non-performing assets, the Committee on Financial System (Narasimham Committee – I) was set up.

For the health and financial soundness of banks in the international level the economic reforms were initiated (Pathak, 2009). With the mutual consent and debate of the participants who reinforcing to the overall economy the economic reforms have undertaken (Badola and Verma, 2006). These reform measures substantiate the views that highlight the key role in economic development that could be played by a banking system free from the types of controls on interest rates and quantities that were Two decades had completed since the banking sector initiated measures to uplift the banking sector in line with international standards and to improve productivity and efficiency of banks. Many researches on NPA illustrated the relationship between asset quality and financial distress and considered management of NPA as a major prerequisite to counter the recessionary pressures and foster economic development. Some of the major observations from previous researches include;

✓ the problem of the NPA is severe in countries where severe government intervention had led to the institutional decay of banks or prevented their sound development (Renaud, 1997)
✓ In banks priority given to NPA management over other aspects of bank functioning (Batra, 2003)
✓ The existing capital adequacy norms tried to avoid bankruptcy, but impacted availability of funds for productive purposes. (Murinde and Yaseen, 2004)
✓ It is not necessary reduction in NPA ratios also reduce fresh NPA. For ex, Banks have aggressively provided for their bad debts from the treasury profits during 2003-04 in order to
show a better NPA picture, resulting a decline in NPA by 24.7% as against a decline of 8% in 2002-03. (Pathak, 2009)

✓ The significant threat to Indian Banking Sector was NPAs (Estrella et al, 2000; Gopalakrishan, 2004; Heid and Kruger, 2011)

The Slowdown in economic growth and rapid credit growth are independently associated with higher levels of NPA (Bock and Demyanets, 2012) upon analyzing the banking sector in India, it is evident that the NPAs still pose a significant threat to the banking sector. In this research an attempt is made to examine the non-performing assets of public sector banks (PSBs) in India and to evaluate the impact of Securitization Act 2002 on NPAs of PSBs conducted using banker’s perception on incidence, impact and management of NPA, and Many measures were initiated since 2000 to effectively manage the menace of NPA. Further, limited studies have been done on the effectiveness of various measures taken from the post-millennium period for the recovery of the NPAs, including One Time Settlement scheme, Debt Recovery Tribunals (originally established in 1993, significant amendment was carried out during 2003), Corporate Debt Restructuring (2001), SARFAESI (the act was passed during 2002) and Asset Reconstruction Company (ARC).

Despite the various prudential measures taken from the post – liberalization period, the non-performing assets still pose an important threat to the very existence of banking. From `636.09 billion in 2000-01, the total gross NPA (GNPA) has increased to `979.25 billion in 2010-11 and `1,423.26 billion in 2011-12. In percentage terms, Gross NPA increased to 45.3% in 2011-12, compared to 15.7% increase during the previous year. Similarly, from 314.63 billion in 2000-01, the total net NPA (NNPA) has increased to 418.15 billion in 2010-11 and 649.75 billion in 2011-12. In percentage terms, the net NPA increased to 55.6% in 2011-12, compared to 7.7% in the previous year. On the other hand, from 5,407 billion in 2000-01, the total loans and advances increased to 42,975 billion in 2010-11 and 50,746 billion in 2011-12. In percentage terms, the total loans and advances increased to 18.1% during 2011-12. Along with increase of NPA, there exists an increase in the level of loan restructuring in standard advances during the study period. The observation made by Reserve Bank of India in its annual report 2011-12 state that “In the period immediately following the global financial crisis, when asset quality of banks in most advanced and emerging economies took a beating, the asset quality of Indian banks was largely maintained, partly on account of the policy of loan restructuring”. The restructured
standard advances of public sector banks (PSBs) as a percentage of gross advances 5.07% in 2009-10, 4.2% in 2010-11 and 5.92% in 2011-12. The total NPA written off by banks in India during the last 13 years (2000 to 2013) is 100,000 crores. (Chakrabarthy, 2013). The financial analysts and rating agencies that include Moody’s maintained a negative outlook on Indian banking and mentioned that the asset quality of banks would continue to deteriorate especially for Indian Public Sector Banks (Moody’s, 2013). It reiterated the fact that even though the post-liberalization period witnessed significant reforms in the banking sector, the asset quality explained by the level of NPA still worries Indian banking sector, its stability and growth.

1.4 LOAN PROCEDURE IN PUBLIC SECTOR BANKS

All Public Sector Banks in India deployed their mobilize funds by way of loan facilities to generate profit in the banking business by different categories of borrowers.

Loans are offered for avail meant through broadly defined loan procedure which comprises of few steps as under.

1. Borrower fills the application form which furnished, full particulars of himself and his project under a prescribed loan. This application form includes comprehensive detailed information about KYC norms first and then personal details, Bank details, descriptive project details such as line of activity, type of technology, raw materials, supplies, projected 5 years sales figure with the breakup of estimated expenditure and resulting net profit estimate. In the last own financial contribution in the project and the amount of loan required.

2. Above filled application form together with fully furnished details is appraised by competent officers of the Bank who carry out a detailed inspection and verification of the details filled in the application form.

3. After inspection of the form by the officer the search report is submitted. After that senior officer’s analysis the viability of the project to check either considering proposal favorably or declining proposal to the proponent borrower.

4. In this step face to face meeting takes place between senior officers of the Bank and proponent borrower who discuss the terms and conditions of approving loans, which including mortgages, personal guarantees, creation of charges, collateral securities, margins etc. and obtained the acceptance of the terms from the proponent borrower.

5. After sanction of the proposals and its acceptance by the borrower, the borrower creates the mortgages and other securities in favor of Bank according to the sanction terms.
6. After that documents are checked and verify by competent officer of the Bank. The security verification report is submitted to the next higher authority over sanctioning authority considered proposal for noting and endorses the same as “noted" then such noted proposal is sent to the loan department with instruction to release the loan amount.

7. After the disbursement of the fund the inspection is carried out by the Bank for checking the uses of fund, insurance cover, and display of the Bank charges at pledge go down etc. and all findings are recorded on the file of the borrower in the Bank.

8. After that, monthly or quarterly inspections are carried out to assess the working of the project.

9. The internal and external auditor of the Bank verified and audited all the referred steps and its compliance.

**Credit Reference Agency**

CIBIL has been set up for creating a database to be used by the member banks for extraction of credit information reports on the borrowers for considering their request for credit facilities. As a pre-requisite of submission of credit information to CIBIL, consents of borrowers/Guarantors should be obtained. Drawing of CIRs from CIBIL is mandatory for borrowers. The credit rating agency among banks can help in managing NPA by sharing information about the clients. At present, CIBIL (Credit Information Bureau of India Limited) maintain the data of the borrowers that bank and financial institutions may easily access. The RBI also plays an important role by circulating willful defaulters of banks and financial institutions and of borrowers facing lawsuits for recovery. This information is helpful to the banks and FIs for issuing fresh loans to the concerned companies, their promoters or directors.

**1.5 Problem of Non Performing Assets**

Now a day’s granting the loans in the large amount adversely affect the performance and functioning of the banks. Fresh deposits, borrowings, recycling of funds received back from borrowers are used for credit dispensation activities. Non-recovery of installments and interest due adversely affect the credit cycle and the profitability of the banks. For covering the loss of NPAs the banks required to maintain their owned funds by way of capital and the creation of reserves and provisions. Banks try to avoid these losses, but complete elimination of such losses is not possible, bank managements aim to keep the losses at a low level. On the basis of non-performing advances the difference between a good and a bad bank done. Mounting NPAs is a
major problem with a public sector bank with comparative to private sector banks. There are many steps taken by the government to tackle the problem of the NPAs in the banking industry.

The level of NPAs is high in India with comparison to other countries. The RBI initiated many measures for the recovery of the NPAs. There are two committees which deals with the NPAs of Indian banks was a Committee on Financial System and Capital Account Convertibility Committee.

Non-Performing Assets is defined as an asset which ceased to generate the income for the banks and advance where payment of interest or repayment of installment of principal or both remains unpaid for a period of 180 days. However, with effect from March 2004, a norm of 180 days was replaced by a period of 90 days. If the any advances granted by the bank to a borrower become non-performing, then all the advances granted to that borrower treated as non-performing.

1.5.1 The magnitude

The NPAs is the main factor to access the performance of any bank. NPAs of scheduled commercial banks total Rs.70, 904 cr as on March 31, 2002, which form 10.40% of our gross bank credit, about 15.75% of our annual budget and 3% of our Gross Domestic Product. According to the data NPAs increased 5% to 6% every year. In the public sector the amount of the NPAs is 5,000 cr annually, due to the loss of interest income, apart from servicing and litigation costs. The high level of the NPAs adversely affects the profitability of the banks and also old as well as new generation private sector banks and foreign banks. The names of the industries which covers the NPAs are iron and steel and related units like Ferro Alloys; man-made textiles; Real estate / Civil and Project related construction; Pharmaceutical; Leather / goods export; Garment export; Fertilizers and Chemicals; Cement and Cotton (fibers / textiles); Tea / Coffee; Jute; Sugar; and Jewellery / Diamonds.

With comparison to the other countries the problem of NPAs is more in India. NPAs level of different countries are in USA, Japan, Hong Kong, Korea, Taiwan and Malaysia reveal that the ranges from 1% to 8.1% during 1993-94, 0.9% to 5.5% during 1994-95 and 0.85% to 3.9% during 1995-96 as against 23.6% 19.5% and 17.3% respectively for Indian banks during these years.

In many countries, large numbers of banks provisions are general provisions and identified losses are written–off at an early stage. Banks in these countries carry very little NPAs
in their balance sheets. The recovery measures are also very expeditious in view of stringent
bankruptcy and foreclosure laws. The concept of gross NPA and Net NPA is not in vogue in
these countries. In Indian banking, due to time lag involved in the recovery process and the
detailed safeguards/procedures involved before write-offs could be affected, banks even after
making provisions for the advances considered irrecoverable, continue to hold such advances in
their books which is termed as Gross NPA together with the provisions. The provision adjusted
NPAs in Indian banking segment i.e. Net NPAs, constitutes only 8.2% of the net advances of the
banks as on 31\textsuperscript{st} March, 1998 which no doubt is high by international standard but are not so
alarming as Gross NPAs project.

In the year 1991 the economic reforms comes which include Globalization, privatization
and liberalization. It has brought about a positive trend in all the industries not excluding the
Banking industry. But this has also brought about an increase in the NPAs of the Banks which
has affected the bank’s lending, liquidity and profitability. The main goal of the banks is to
recover the NPAs. Non Performing Asset has an alarming threat to the Banking industry in our
country which affects the profitability and performance of PSBs. The measures taken by the
Government of India and RBI for the recovery of the NPAs give the positive results.

Narasimham Committee Reports reduce the effect of the NPA sin the banking sector.
Despite various correctional steps administrated to solve and end this problem, concrete results
are eluding, it is like a virus which effect universally on banking and financial institutions. The
severity of the problem is however acutely suffered by Nationalized Banks followed by SBI
group and All India Financial Institutions. The concept of Asset Quality on the books of Public
sector Banks and FIs came into being when RBI introduced prudential norms on the
recommendations of the Narasimham committee in the year 1992-93. The above norms
have three main criteria:

- Asset classification
- Income Recognition
- Provisioning

1. ASSET CLASSIFICATION

The loans given by the Banks are classified into performing and non-Performing assets
on the following basis:
Performing Assets: also known as standard assets are the assets which do not disclose any problem and which do not carry more than the normal risk attached to the business. Performing asset is one which generates income for the bank. It is an asset where the interest and or principal are not overdue beyond 180 days (modified to 90 days w.e.f. Mar 2004) at the end of the financial year.

Non Performing Assets: An amount is to be treated as non performing asset when it ceases to generate income for the Bank. An asset may be treated as Non Performing Asset (NPA), if interest and/or installment of Principal remain overdue for a period exceeding 180 days (modified to 90 days w.e.f. Mar 04) and Banks and FIs should not take into their Income account, the interest accrued on such NPAs, unless it is actually received/recovered. NPAs are further classified into:

a. Substandard Assets: Loans which are non-performing for a period not exceeding two years, where the current net-worth of the borrower or the current market value of the security, against which the loan is taken, is not enough to ensure full recovery of the debt.

b. Doubtful Assets: Loans which have remained nonperforming for a period exceeding two years and which are not classified as loss assets by for the management or the internal/external auditor appointed by RBI.

c. Loss Assets: Assets where loss has been identified by the internal/external auditor of the bank or the RBI, but the amount has not been written-off wholly or partly. These assets are considered unrecoverable and are of little value to the lending institution.

2. INCOME RECOGNITION

The income recognition is linked to the concept of performance of the assets. In other words, the income from the performing assets only is to be recognized. The income from non-performing assets is recognized only to the extent of actual recovery made during the accounting year.

3. PROVISIONING

The amount of provision required to be created for each asset depends on the classification of the assets, availability/value of security, other guarantee available and the age of the NPA etc. From the foregoing, it may be observed that the prudential norms have the twin effect on the profitability of the Banks: The income from the non-performing assets cannot be
recognized except to the extent of actual recovery. The Bank is required to create a provision for
the nonperforming assets. Both these have a negative impact on the profitability of banks.

**The Period for which the advances have Provision requirement (%) remained doubtful
category**

- Up to one year: 20%
- One to three years: 30%
- More than three years: 100%

Banks are permitted to phase additional provisioning consequent upon the reduction in
the transition period from substandard to doubtful asset from 18 to 12 months over a four year
period commencing from the year ending March 31, 2005 with a minimum of 20% each year.

Further, when NPA account is 5 yrs and above than the economic life of the asset finance
is over and it’s presumed that the realizable market value of such NPA's is either negligible or is
often less than 1 % of the outstanding loan balance. Such an asset are classified as loss assets and
100 % provision has to be made in case of NPA's with the status of loss assets. However,
generally Banks carry out critical inspection of its assets, its economic life and its economic life
and its estimated realizable value of security based on market condition and placed their findings
in the records on the basis of which assets are classified as loss assets and provision is 100%
made. Often auditors are involved in the judicious assessment of the status of loss assets so that
decision for making 100 % provisions remain justified. As may be noted from the above referred
assets classification in all the cases and categories of NPA’s Banks are mandatory require to
make provision on NPA’s at 10 %, 20 %, 30 %, 50 %, 100 % respectively for substandard,
doubtful and loss assets. It is importantly Banks are mentioned here that as per the recent
guideline of RBI, require to make 0.25 % of provision for agricultural and SME sector and
0.40% for others. So that when they eventually turn potential NPA's then Banks may have some
cautions to service provision requirement. Thus, it may be seems that for complying with
prudential norms Banks may have to review the health of the credit portfolio at regular intervals
and based on asset classification. It should keep building provision reserve to meet with eventual
loss that may have absorbed by the Bank in the case where all the efforts including legal actions
and sale question of asset finance failed to meet with an outstanding loan amount and interest
amount.
With foregoing in the considerable it may be noted that 100% provision amount in case of loss assets can help the Bank write off entire loan outstanding balance against 100% provision reserve, which was built from the early stage of NPA's in proportion of 10% of sub standard to 100% of losses. Such write off is conveniently booked in the balance sheet because of the provision made from time to time out of Banks profit. However, in case where the Banks do not have an adequate profit to meet with requirements then such provisions are to be made even by incurring loss. Thus, more NPA's needs more provision amount result either in diminishing profit or increasing net losses. Needless to mention that Bank balance sheet showing accumulated losses reflects erosion in Banks net worth because net worth means capital reserve less accumulated loss. Therefore, in simple words, losses accumulated due to the huge provisioning amount of NPA's finally eat into equity capital and reserve of the Banks. Such consistent status can implicate the Banks (erosion) of the Banks capital structure. Therefore, at the time of granting loans and advances the risk weight age has to be assessed based on stipulated formula guideline and such risk weight age should be equivalent to the total capital structure of the Banks. In simple words Banks entire capital (tier 1 and tier 2) together should be equivalent to the 9% of the total risk weighted as assessed in the credit portfolio of the Banks. Banks having capital structure equivalent to 9% or more of the total credit risk weight age are called as Banks which are Basel I compliant, since this requirement of 9% capital adequacy was recommended by Basel committee. Above referred description clearly bring out the relevance of NPA's and its impact on capital adequacy.

As earlier stated in the introduction, the M. Narasimham Committee recommendation was considered and as a first step towards economic reforms, the Government of India with the help of RBI introduced the prudential norms in the Indian Banking system. Banks were directed to strictly comply with RBI directives for income recognition and provisioning and asset classification. The whole exercise was prescribed for successful implementation in 3 years time during which RBI had also issued very strict guidelines for statutory auditors who were accounted responsible for the desired compliance. All the Public Sector Banks had no option but also require implementing in later in strict norms of income recognition but also requiring identifying NPA’s and making adequate provisioning in a phased manner. The final balance sheet of Banks being subject to statutory audit, the Banks had to evolve a new model or bookkeeping and statutory accounts to make balance sheet more transparent. Finally, clean and
absolute transparent balance sheet in line with the Basel committee recommendation and thus most of PSB’s started presenting clean and transparent balance sheet after 1999.73 The entire cleaning up of exercise took 5 years time from 1994 onwards during which many PSB’s reported huge losses amounting between 500 to 1000 crore. However, such an exercise made Bank management aware of serious threats posed before them for managing above 1 lakhs crore of NPA’s. Such a magnitude and volume of huge NPA’s and for infusing more capital at finally sensitise Government of India which had by that time triggered irreversible economic reforms. The issues of 1 lakhs crore NPA’s in Indian Banking system and need for augmenting necessary capital as per prescribed Basel norms, were strongly deliberated between Banking department of (GOI ) Government of India, RBI and (G o M) Group of Ministers in the central cabinet. After seriously pondering over the said issue, the Government of India emerges with the consensus to present a bill in the parliament giving substantial autonomy to the management of PSB’s in releasing the blocked funds in the NPA’s account by lawful recovery means as formulated in the forms of Securitization Act of 2002. For the first time Banks management were equipped with sharp result orienting tools of the Securitization Act to realize long term NPA’s. Under the Act Banks were authorized to attach immovable properties of the defaulting borrowers and sale through auction of such property, the proceeds of which were directly receivable by the Bank for appropriation in borrowers NPA’s account. Leveraging on Securitization Act and on other hand very efficiently manage their treasury operations in the vibrant booming economy of the country, the profit from which were largely servicing provision needs on other hand. Thirdly the Government on improvement on balance sheet structure permitted Public Sector Banks to offer equity share to the Indian Public and Financial Institution at premium by reducing their own stake to around 55 to 60 % from 100% to 80 %. Thus Government continued to enjoy the status of largest shareholders holding more than 51 % share on the other hand to enjoy ownership rights, while offer for sale of equity shares at premium helped Bank of raise resources for complying with Basel norms.

The Government produced three types of strategies for meeting with the international Banking standard by achieving reductions in NPA’s to the tune of less than 5 % of total credit as also have capital adequacy of 9 % which is equivalent to the risk weight age in credit portfolio of PSB’s.
(i) Securitization enforcement helped to realise long due of NPA's and thus reduction in NPA's was achieved.

(ii) Service provisioning requirement of asset classification generated sufficient profit with the help of effective management of treasury operations.

(iii) Improved balance sheet could attract a premium on sale of equity shares following decreases of the Government stake to less than 60% but more than 51%, which helped meet with the capital adequacy requirement in lying with Basel 1 norm.

1.5.2 IMPACT OF NON PERFORMING ASSETS

At the Macro level, NPAs has directly affected the supply of credit and decrease the capital formulation and arresting the economic activity in the country. And in the Micro level, increasing the level of NPAs has affected the profitability and performance of the bank. The interest income is decreasing and increase in the provisions of the banks. It also affects the capital base and competition of the banks. Due to increase in the level of NPAs increase the cost of credit, which made Indian businessmen uncompetitive as compared to other countries. It has made Banks risk averse and squeezed genuine Small and Medium enterprises from accessing competitive credit.

General causes for Non Performing Assets

In priority sector advances-
- Directed and pre-approved natures of loans sanctioned under sponsored programmers.
- Mis-utilisation of loans and subsidies.
- Diversion of funds.
- Absence of security.
- Lack of effective follow-up (post-sanction supervision& control).
- Absence of bankruptcy and foreclosure laws.
- Decrepit legal system.
- Cost ineffective legal recovery measures.
- Difficulty in the execution of decrees obtained.
- Lack of marketing support

In Non Priority Sector Advances:
- Improper and inadequate credit appraisal.
- Demand recession.
✓ Frequent changes in Government’s policies.
✓ Industrial sickness and labour problems.
✓ Antiquated legal & judicial system.
✓ Lack of legal reforms (Bankruptcy Foreclosure laws).
✓ Diversion of funds.
✓ Willful default.
✓ Technology obsolescence.
✓ Incompetence-Management failures.
✓ Fear psychosis among Banks & lack of effective follow-up (policing of assets by Banks)
✓ Political compulsion and corruption.

1.5.3 Measures to tackle the Non performing assets

Non – Legal measures

1) Preparation of ‘know-your client’ profile.
2) Reminder system
3) Seasonal/Area based recovery drive
4) Follow up of Potential NPA
5) Review of NPA account
6) Preparation of village wise/Area wise list
7) A Visit to Borrower’s business premise/Residence
8) Allotment of NPA account to staff
9) Recovery camps/Settlement camp
10) Road shows
11) Appointment of professional Recovery Agents.
12) Rehabilitation of sick units
13) Corporate debt Restructuring
14) Lok adalat /lok nayalaya
15) Circulation of list of defaulters
16) Recalling of advances
17) Recovery through Recovery Branches
18) Up gradation of NPA
19) Cash Recovery
20) Recovery through compromise cases
21) Revival of failed compromise cases
22) Recovery of written-off cases
23) Restructuring / Rescheduling
24) Sale of financial Assets (Asset Reconstruction companies)
25) Write-off
26) Credit Rating System
27) Identification of watch-list/special category accounts
28) Measuring of early warning signals

**Legal Measures**

1) Recovery through the Judicial process (Filing of suit)
2) Execution of decrees cases
3) Debt Recovery Tribunals (DRT)
4) Securitization and Reconstruction of Financial assets and Enforceability of security interest Act 2002 (SARFAESI)
5) Other legal measures

1. **Lok Adalats:** Lok Adalats have been set up for recovery of dues in accounts falling in the Doubtful and loss category with an outstanding balance up to 5 lakhs, by way of a compromise settlement. PSBs filed 16,36,957 cases involving Rs. 232 billion in the year 2013-14. They have been able to recover Rs.14 billion only upto Dec.2104. This mechanism has however, proved to be quite effective for speedy justice and recovery of small loans.

2. **Debt Recovery Tribunal (DRT):** 22 DRTs have been set up in the country during the last half a decade. DRTs have not been able to deliver, as expected as they got swamped under the burden of a large number of cases filed with them since their inception. The banks filed 28,258 cases involving Rs.553 billion in the year 2013-14. Out of this amount DRTs have been able to recover 53 billion in the year 2013-14.

3. **One Time Settlement Schemes (OTSS):** One Time Settlement Schemes launched in May’99&July’00 have enabled Banks to recover Rs.668 crore and Rs.2600 crores respectively by Sept. 2001. One more OTSS for the outstanding amount in default upto 10 crores has been introduced in the month of Feb’03 its results will be seen in due course.
4. **Corporate Debt Restructuring (CDR):** CDR is a non-statutory mechanism started in the year 2001 which provides a transparent mechanism for restructuring corporate debts of Rs.20 crores and above, of viable entities financed by the Banks and FIs under **consortium or multiple banking arrangements.** It is a voluntary system based on debtor-creditor agreement (DCA) and inters creditor agreement (ICA). At present 10 FIs and 49 Public and Private sector Banks are the members of the CDR mechanism.

**CDR system** is applicable to the standard and sub-standard loan accounts. However, as per latest modifications, viable doubt-full assets can also be taken up for restructuring based on the consensus among at least 75% of the lenders. Reference to CDR could be triggered by:

a) Any one or more of the secured creditors who have minimum 20% share either in working capital or term finance.

b) By the concerned Corporate, if supported by Banks and FIs having a stake as in (a) above.

**Structure:**

CDR has the following 3-tier structure:

1. **CDR standing forum:** It is a representative general body of all Banks and FIs participating in the CDR system. It is a self-empowered body, which evolves broad policy guidelines and guides and monitors the progress of CDR.

2. **CDR empowered group:** This group examines and takes decisions on the proposals recommend to it by the CDR cell for restructuring of the corporate debts.

3. **CDR cell:** It initial received proposal from the borrowers and lenders. Firstly the borrower approaches his Lead Bank/FI with a request to restructure debt, which in turn puts up the proposed to the CDR cell. BIFR, DRT referred, willful defaults, unviable doubtful and loss accounts and suit filed cases are outside the preview of CDR. The banker/borrower cannot take any legal action before the period of 90-180 days. Once the reference is made to CDR mechanism.

4. **Super Majority Concept:** In case, any restructuring is approved by CDR by not less than 75% of the secured creditors, it becomes binding on all secured creditors even if minority secured creditors have different mandate. However, RBI recently fine-tuned CDR guidelines in this regard and has now given the lenders the option to exit from the package by selling their exposure to either the existing or fresh lenders at an appropriate price to be decided mutually. This move has given Private Banks, Foreign Banks and PSBs, who have minority
share in consortium a big breather, as they were not comfortable with the mandatory system. The new lenders will rank on par with other lenders for repayment and servicing of dues, since they have taken over the existing dues.

**CDR is not applicable to accounts involving only one Bank or one FI, even though it has an exposure over Rs.20 crores or more.** While the arrangements under the CDR scheme seem to be feasible from the debt restructuring perspective, its success depends upon the cooperation extended by the borrowers and the bankers on one hand and understanding among Banks and FIs on the other. Presently the CDR scheme is its infancy stage, but if implemented in its entirety with support from all the aggrieved parties and the Government, it can help facilitate speedier recovery of NPAs. A Mechanism like debt for equity swap could prove to be effective in solving the NPA problem, especially in cases of unwillful default, wherein despite strong fundamentals, the company defaults due to some extraneous factor.

**1.5.4 CAPITAL ADEQUACY**

In the year 1998 RBI introduced BASEL I norms of capital adequacy for Public Sector Banks and Private Sector Banks. Many Private Sector and Co-Operative Sector Banks going into liquidation due to unrecoverable huge loans (NPA), RBI found out that such sick Banks had extended huge portfolio which was disproportionately high against their paid up capital. Banks had no other sources left with them to service their expenditure due to turned the banks net worth negative by an increase in the level of the NPAs. Such status created certain in securing amongst depositing community who queued up outside the premises of sinking Bank's. Naturally the faith with which they had placed their money with Banks had been utilized and spent by the Banks without any prospects of recovery from bad loans and hence depositors were likely to end up as losers of their good money.

The government of the India provides budgetary support in the foam of bailout packages to maintain the confidence of the public at large in the financial system of the country. But such financial support and bailout packages cannot be extended time again.

Therefore, Government of India had directed to RBI to fix the prescribed proportions of the loan amount according the capital Adequacy norms. Initially RBI had fixed the capital adequacy ratio of minimum 8% of tier I and tier II capital which should be equivalent to risk weight age elements in the loan portfolio of Banks. The risk weight age is assessed on the basis of the type of loan and nature of security offered by the borrower.
For Example

Loan of Rs 75 allowed against the bank's own fixed deposits of Rs 100 is considered fully secured and hence the risk weight age in this case is Zero and therefore no 8% capital requirement is necessary. However, a loan for Rs 100 to retail traders against stock of grains is considered unsecured loan and hence the loan amount of Rs 100 is assessed as the risk weight age for entire loans of Rs 100 under the circumstances in this case against risk of Rs 100, Bank must allocate Rs 8 capital to meet with RBI stipulated capital adequacy norms of 8%.

The capital adequacy ratio indicates the margin of protection available to both depositors and creditors against unanticipated losses that may be experienced by the Banks. Based on Narasimham Committee - II report, RBI stipulated that the minimum capital to risk assets at 9% should be achieved by Commercial Banks by March 2000. Risk based capital norms help the Banks to evaluate more prudently the risks and benefits of their portfolio choice, apart from giving wider security blanket for depositors. In fact, good quality adequacy norms show the improvement inequality of lending.

Now there is an upward revision in capital adequacy norms and RBI stepped up capital adequacy requirement from 8% to 9% and today it is 10%. Now above condition take care in respect of capital adequacy against risk of only loan portfolio. But in recent the time it has been experience of various Banks that, beside the risk of the loan elements there also exist another risk called as operational risk. Under this the capital adequacy provisions are prescribed for covering and insulating Banks from risk of operational hazards like losses occurring due to fraud, financial scam terrorist attack, natural calamities like Tsunami, earthquakes etc. Additional allocation of capital to cover above referred operational risk is prescribed as Basel II norms which are in operation with the developed countries in the western part of the world. Basel II norms have been introduced very recently in the Indian financial system and in the absence of available historical data, the financial system of the country has so far not made a fair assessment of operational risk. However, under the directives of RBI, various Banks have initiated exercises for assessing operational risk via a this requirement of additional capital and most of the Public Sector Banks have already launched their second public issue to raise the capital so that above referred requirement stated to be Basel II norms is complied with.
1.5.5 Basel II

To cover the operational and credit risk the first time Banks in India could considered required proposition of complying with the Basel II norms. Until recently, in the absence of capital adequacy Banks were not in a position to consider the assessment of operational risk. However, improved financial status as stated above, and with full compliance with Basel I, Banks immediately undertook an exercise to assess operational risk on one hand and make a judgment to raise additional capital on the other hand to cover such operational risk, so that they can turn as Basel II compliant Banks in two years time say by 2007/2008. This two/three time beginning from 2005-2006 is the minimum time for Banks to judiciously access their operational risk vis-à-vis. While the critical area of needs for availability of historical data and transparent sectorial segregation of a business line or business mix, it is imperative to prepare minimum groundwork so that the capital requirement to comply with Basel II norms is cost effectively managed.

Thus, in first instance, before going into various method of assessing operational risk and then considered one of the four or five available options, Banks in India have to have very clear and dependable technology in place which be used as efficient tools to generate historical data on one hand and segregate business line activities on the other hand. Needless to mentioned that historical data will unfold past performance of Banks clearly indicating the losses and hits taken and absorbs by the Banks on operational front due to frauds, scam, burglary, theft, weak control system, obsolete technology, etc on other hand efficient technology tools should also make available data on Banks sectorial exposure at a given time in different segment of economy such as retail segment, corporate segment, commercial segment, plastic money and other miscellaneous financial service. Above referred to main areas viz. historical data and business line activities are the focused portion of the Banking systems which deals with assessing operational risk.

Thus, minimum basic inputs now remaining available and accessible (As stated above), the Banks in India kick started the exercise of taking concrete steps in this direction of becoming Basel II compliant. Most of the Banks having made some judgmental on their operational risk with the help of (1) Historical Data (2) Segregation (Sectorial assessment of business activities.) It may be mentioned here that the buoyant economy of the country growing at over 8 % in terms of GDP between 2007 to 2010,
very healthy Balance sheet structure with less than two percent NPA and more than 10% CAR, as also a substantial global financial investment (FII) to tape infrastructure boom, the banks could not have coupled that a time this launch their second public issue with substantial premium so that huge capital reserve can put in place to meet with the necessary provision under BASEL II norms to cover operational risk.

**Reason for Basel II**

Risk management is an important business differentiator due to rapid economic growth. Basel II norms provide a methodology for transforming Banks into vibrant and stable entities in the globally competitive and dynamic financial markets. It points towards RAPM (Risk Adjusted Performance management) methodology and RAROC (Risk Adjusted Return on Capital).

The main focus under Basel I norms is to minimize the perspective levels of regulatory capital, across credit and market risk, to minimize the operational risk introduced first time. With increasing transnational complexities, multiplicity of technology platforms and various product innovations, Banks faces a number of operational risks which could affect their market reputation. Norms of Basel II covers the risk which doesn't come under the Basel I. Pillar III brings into play the importance of market driven disclosures to peers and other stakeholders.

**Improved Version of Basel III Introduced by RBI**

In 2010 after the guidelines prescribed in Basel I and Basel II accord in 1988 and 2004, an advanced description in the form of Basel III agreement has finally appeared laying much needed pressure on peak value funds that the Banks should hold adequately to invest them through periods of financial stress. It revised the core tier I capital ratio to 7% of risk bearing assets and also recommended ratios to compute and observe liquidity risk as well as those which were earlier not considered in Basel I and II capital Accords.

**1.6 SARFAESI ACT 2002**

The need for the setting up an asset reconstruction company arise due to make the Assets off the balance sheet of the Banks and FIs with a view to develop a market for such assets was being felt, since long. Narasimham Committee 1 & 2 and the Verma Committee on restructuring of weak Banks has strongly recommended the setting up of Asset Reconstruction Companies (ARCs) there are mainly two purpose for which the business of Securitization and Reconstruction run:

- To regulate the business of securitization and reconstruction of the financial interest
To regulate enforcement of the security interest and for the matters connected therewith or the matters incidental thereto.

The Act empowers the banks to change or take over the management or even take possession of secured assets of the borrowers and sell or lease out the Assets. This is the first time the banks can takeover the immoveable assets of the defaulting corporate. No court, other than the Debt Recovery Tribunal can entertain an appeal against the action taken by the banks under this Act.

Since the enactment of the securitization Act, it was seen as a panacea to the entire problem of NPAs. Defaulting borrowers who were not responding previously started responding favorably and cash recoveries became a reality.

For enhancing the liquidity of the Banks and FIs the term debt securitization is used which is new in the market. It provides extended financial assistance to the borrowers for various purposes. The debt securitization makes available to these institutions the security papers against the financial assets which have been created out of the financial assistance sanctioned and disbursed by these institutions and in the case of a default by the borrowers the secured creditors can have recourse to either the securitization of the asset or the reconstruction of the same.

Special purpose vehicles (SPV) issues the tradable securities against the loans which transfer by the originator and these are issued to the investors with the help of the securitization process. The ARCs acquired the financial asset from the ‘originator’ whether by raising of funds by the such securitization company from ‘qualified institutional buyer’ or by the issue of security receipts who have undivided interests in such financial assets or otherwise. There must be some sort of understanding between the QIBs and the securitization company which can be ‘originator’ in the case of the banks and the FIs which has extended the financial assistance to the ‘obligor’ who is supposed to repay the financial assistance in installments on some future dates as per the agreement entered into by it with the bank. This can be referred to as the ‘security agreement. Security interest’ is created in favor of the secured creditor with the help of this instrument which creates the mortgage by the deposit of the title deeds with the secured creditors.

1.6.1 Salient features of Securitization act

The secured creditor has two rights under the Act. It can either transfer the Security Interest to ARCs or enforce the provisions of the Act on its own, without the intervention of the
court. As per Section 35, the provisions of this Act override all other laws for the time being in force notwithstanding anything inconsistent therewith contained therein. Further, as per Section 37, the provisions of this Act or the rules made thereunder are in addition to and not in derogation of the Companies Act, 1956, Securities Contract (Regulation) Act, 1956, the SEBI Act, 1992 (15 of 1992) and Recovery of Debts due to Banks and Financial Institutions, Act, 1993 (51 of 1993) or any other law for the time being in force.

1) The Secured Creditor may require the borrower to give notice in writing to discharge his liabilities within 60 days from the date of the notice, if the borrower fails than the Secured Creditor can exercise all or any of the following rights under sub-section 13 (4) to recover his Secured Debt.
   a. Take possession of Secured Assets of the borrower, including, by the way of lease, assignment or sale for realizing the Secured Assets.
   b. Take over the management of the Secured Assets of the Borrower.
   c. To manage the secured Assets the secured creditors also appoint any person as Manager.
   d. Required any person who acquired the secured Assets whose money is due and payable to borrower and who to pay the same to the Secured Creditor, as is sufficient to repay the secured debt.

2) No Secured Creditor will be entitled to any or all of the above-said rights conferred on him u/s 13 (4) of the Act, if the financial Assets have been jointly financed by more than two secured creditors.

3) If the full amount of the secured creditors is not fully satisfied by the sale proceeds of the Secured Assets than the Secured Creditor can file an application with the Debt Recovery Tribunal or a competent Court of Law for recovery of the balance amount from the Borrower.

4) Secured Creditors can proceed against the guarantors or sell the pledged Assets without first taking any of the measures specified in clause (a) to (d) of sub-section 13 (4) in relation to the Secured Assets, under the Act.

5) By publishing a Notice in newspaper in English and any other Indian language of the area, in which principal office of the borrower is situated the secured creditors can take over the management and appoint Directors where the Borrowers is a company or Administrator of the business.
6) The borrower cannot alienate the Secured Assets in question when the notice preparatory to repossession is received.

7) Banks can package and sell Loans via Securitization. Loans can be traded among Banks, like Bonds or Shares.

8) In the following transactions the Act is not applicable.
   a. Any Security Interest created in the Agricultural Land.
   b. Any Debt where the amount due is less than 20% of the Principal amount and Interest thereon.
   c. Any Security Interest for securing repayment of any financial asset not exceeding Rs. 1 lakh.
   d. Pledge of Movable assets within the meaning of section 172 of Indian Contract Act 1872.
   e. Any conditional sale, hire purchase or lease or any other contract in which no Security Interest has been created.

9) If the banks take the possession of assets than the right to appeal is also given to the borrowers. The aggrieved borrower can file appeal u/s 17 before the DRT within 45 days from the date of initiation of steps, though 75% of the amount stated in the notice or such lower amount as DRT may direct, is required to be deposited with the DRT concerned. Similar right of appeal before DRAT within 30 days is given u/s 18 to any person aggrieved by the order of the DRT. Thus the Act restricts frivolous or dilatory appeals. The Act ousts the jurisdiction of the Civil Courts and mandates that no Injunction shall be granted in respect of any exercise of rights conferred by or under this Act.

1.6.2 Action taken by banks

Banks and financial institutions have already started taking action under this Act swiftly. Notices have since been flashed to thousands of borrowers involving several thousand crores of NPAs. With the enactment of the Act the borrowers have now seen the writing on the wall and have started responding positively who earlier never responded the calls of the Banks. Now they are coming to the banks for settling their dues. The settlements are being reached as per RBI norms and banks' own recovery management policies. Cash recoveries have started pouring in. Where the borrowers have not responded to the 60-day notices, the banks have tightened the noose and have started procuring Seizure Orders from District Magistrates (DMs) or Chief Metropolitan Magistrates (CMMs). Secured Assets have since been seized in several cases,
which have compelled even hard-core defaulters to pay their dues. Never before the banks have received such an overwhelming response to any recovery measure taken by them earlier. Print media too is playing its part in building up the euphoria by giving wide publicity to the steps taken/being taken by banks. Despite the initial hiccups, recovery of NPAs is gathering momentum. With the introduction of the Act the assets go off the balance sheet of the originator and thus the capital requirement has reduced.

**Securitisation as financial product**

Securitisation is considered as a financial product and the bonds/debentures can be issued based on the future installments against the financial assistance already sanctioned and disbursed by the banks and financial institutions.

1.6.3 Some important terms of the concept of securitization:

1. **Qualified Institutional Buyer:** It can be any financial institution, insurance company, banks, state industrial development corporation, trustee or any asset management company making investment on behalf of any mutual fund/ provident fund /pension fund or any foreign institutional investor which may have to be registered with the SEBI or any other corporate body which can be specified by SEBI.

2. **Originator:** The bank or the FI which offers the financial product.

3. **Obligor (borrowers):** The client whose future installments are securitized.

4. **Security receipt:** is a receipt or any other security issued by a securitization company to a QIB regarding an undivided right, title or interest in the purchase or the acquisition in the financial asset involved in the process.

5. **Security agreement:** An agreement or any other document under which security interest is created in favour of the secured creditor.

6. **Security asset:** means the Assets on which the security interest is created.

7. **Secured creditor:** Includes any bank or financial institutions or any groups of banks and financial institutions.

8. **Secured debt:** means a debt which is secured by security Interest.

9. **Secured interest:** means give right, title and interest of any kind, whatsoever upon the Asset.

10. **Sponsor:** means any person holding not less than 10% of the paid-up equity capital of a securitization company or reconstruction company.
11. **Borrower:** means any person who has been granted financial assistance by any bank or FIs who has been given any guarantee or created any mortgage as security.

12. **Default:** means non payment of any principal debt or interest thereon or any other amount payable by a borrower.

13. **Financial Assistance:** means any loan or advance granted or any debentures or bonds subscribed or any guarantees given or letters of credits established or any other credit facility extended by any bank or FI.

14. **Financial Asset:** means debt or receivable and includes:

   ✓ A claim to any debt or receivable or part thereof, whether secured or not.
   ✓ Any debt or receivable secured by mortgage of or charge on immovable property.
   ✓ Mortgage, charge, hypothecation or pledge of immovable property.
   ✓ Any right or interest in the security whether full or part underlying such debt or receivable.
   ✓ Any beneficial interest in property, whether immovable or movable or in such debt, receivable whether such interest is existing, future or accruing, conditional or contingent.
   ✓ Any financial assistance.

   The need for the securitized asset and its transfer may be required by the originator to increase its liquidity and handle the non performing assets (NPAs) effectively.

   **The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002** popularly called the Securitisation Act has provided an enabling legal framework for the setting up of securitization or reconstruction company and the manner of acquisition of financial assets by such companies. **Commencement of the Act.**

   The Act has been made effective from 21st June 2002, the date on which the first securitization and reconstruction of financial assets and enforcement of the security interest ordinance, 2002 was promulgated. This Act has been enacted to help Banks and FIs to tackle the NPA problem.

   This Act can be broadly divided into four heads:

   ✓ Securitisation of assets
   ✓ Enforcement of security interest
✓ Setting up of Central Registry
✓ Establishment of an ARC

The two terms which have been used in the Act which are of special significance are:

The security Interest
Financial Asset
The Act has explained these two terms in section 2(1) (zf) and 2(1)(L) as:

‘Security Interest’ means right, title and interest of any kind whatsoever upon property, created in favor of any secured creditor and includes any mortgage, charge, hypothecation, assignment other than those specified in section 31.

‘Financial Asset’ means debt or receivable and includes:
✓ A claim to any debt or receivables or part thereof, whether secured or unsecured.
✓ Any debt or receivables secured by, mortgage of, or charge on, immovable property
✓ A mortgage, charge, hypothecation or pledge of movable property
✓ Any right or interest in the security, whether full or part underlying such debt or receivables
✓ Any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent
✓ Any financial assistance.

Purpose of the legislation:-

Our existing legal framework relating to commercial transactions does not work with the changing commercial practices and reforms in the financial sector. So that the default loans was not recovered and increase in the levels of non-performing assets of Banks and FIs. Narasimham committee 1&2 and Andhyarujina Committee constituted by the Central government for the purpose of examining banking sector reforms have considered the need for changes in the legal system in respect of these areas. These committees, interalia, have suggested enactment of the said Act for the securitization and empowering banks and FIs to take possession of the securities and to sell them without the intervention of the court.

The provisions of the ordinance would enable banks and FIs to:
✓ Realise long-term assets
✓ Manage problem of liquidity
✓ Manage Asset-Liability mismatches and
✓ Improve recovery
These could be achieved by exercising powers to take possession of securities, sell them and reduce NPAs by adopting measures for recovery or reconstruction.

**Provisions/Highlights of the Act**

The Securitisation Act contains provisions to provide for the following:

a) Registration and regulation of securitisation companies or reconstruction companies by the Reserve Bank of India (RBI)

b) Facilitating securitisation of financial assets of banks

c) Easy transferability of financial assets by the Securitization Company or Reconstruction Company to acquire financial assets of banks and FIs by the issue of debentures/bonds or any other securities in the nature of a debenture

d) Empowering securitization companies/reconstruction companies to raise funds by the issue of security receipts to qualified institutional buyers

e) Declaration of any ARCs registered with the RBI as a public financial institution for the purpose of section 4A of the Companies Act, 1956

f) Defining “security interest as any type of security including mortgage and charge on immovable properties given for due repayment of any financial assistance given by any bank or FIs

g) Empowering banks and financial institutions to take possession of securities given by the borrowers for financial assistance and sell or lease the same or take over management in the event of default, i.e. given classification of the borrowers account as NPA in accordance under the guidelines issued by the RBI from time to time.

**Certain provisions of this Act to apply after Central Registry is set up or caused to be set up**------‘The provisions of sub-sections (2),(3) and (4) of section 20 and sections 21, 22,23, 24, 25, 26 and 27 shall apply after the Central Registry is set up or caused to be set up under sub-section(10)of section 20. No Asset Reconstruction Company or Securitisation company can commence or carry on the business of Asset Reconstruction or Securitisation

✓ Without obtaining a Certificate of Registration to be granted under section 3 of the Securitisation Act, 2002
✓ Without having owned funds of not less than Rs.2 crore or such other amounts not exceeding 15% of total financial assets acquired or to be acquired by such company, as the RBI may notify.

All ARCs or Securitisation companies, which are in existence at the commencement of the Act, shall make application for registration to RBI before the expiry of 6 months from such commencement. All ARCs are to be regulated and registered with the RBI. There will be a Central Registry and Central Registrar, to whom details of all individual transactions are to be reported, on an on-going basis.

1.6.4 ASSET RECONSTRUCTION COMPANY LIMITED

The word Asset reconstruction firstly used in Narsimham I report in which fund is contributed by the Central Government. An economy is adversely affected by the high level of NPAs in the banking system. So, the banks become risk averse in granting the new loans specially small and medium sized companies. The greatest attention is required to resolve the problem of NPAs. ARCs have been used all over the world to resolve the problem of NPAs. ARCs act as “Clean Bank” in the banking system.

ARCs are like the lenders and have all the rights same like lending banks. There are total 14 ARCs in India, some of them promoted by some banks coming together: the first ARC was ARCIL, which was sponsored by SBI, ICICI bank, IDBI bank and PNB. The main purpose for establishing ARCs under SARFAESI Act is to enable banks to clean up their balance sheets. The full time attention to realize a higher amount of recovery is given to the agency. ARCs must register under the sec 3 of Securitization Act 2002 and net owned funds of at least 2.00 crores or such other amount specified by the RBI. Time to time RBI notify different amount of net owned fund for different classes of Securitization Companies. Every ARCs required to give an application to the RBI within 6 months from the commencement of the business. ARCs cannot start its business until a certificate of registration is not granted. There are some conditions fulfilled by the ARCs for issue of registration of the certificate by the RBI:

(i) The company should not incur losses in any of the 3 preceding financial year.

(ii) It has made financial arrangements for realization of Assets and it must be able to ay periodical returns.
(iii) The sponsor is not a holding company.
(iv) The director must have professional experience related to finance and reconstruction.

According to the RBI notification ARCs perform the following functions:
(i) Acquisition of the financial Assets
(ii) Change in the management /sale or lease of the business.
(iii) Enforcement of security interest aspect according to sec 13(4) of SARFAESI Act 2002.
(iv) Rescheduling of the debts.
(v) Settlement of dues payable by the borrowers.

According to the RBI, the Act has made provisions for the registration and regulation of ARCs which facilitate the securitization of financial assets of banks, empower SCs/ARCs can raise funds by issuing security receipts to qualified institutional buyers (QIBs). There are three alternative methods for recovery of NPAs provided by the Securitization Act 2002, namely Securitization, Asset Reconstruction and Exemption from Registration of Security Receipt. They are dealt below:

- **Securitization:** under the securitization the ARC Company issues the security receipt. After that the ARC Company raises funds from the QIB by forming schemes for acquiring financial assets. The SC/ARC shall maintain the separate accounts for each and every financial asset acquired. To check the investments made by a QIB and realization of such financial asset is held and applied towards redemption of investments and payment in the form of return is paid under the scheme.

- **Asset Reconstruction:** The SCs/ARCs provide the following measures: to take possession on the management of the business, to sale or lease of a part or whole of the business of the borrower, according to the enforcement of the security interest provision of this Act rescheduling of the payment made by the borrower and taking possession of the secured assets for the settlement of dues payable by the borrower in accordance with the provisions of this Act.

- **Exemption from Registration of Security Receipt:** The Act provides, notwithstanding anything contained in the Registration Act, 1908 for enforcement of security without the intervention of the court: (a) According the section 7 of the Act any security receipt
issued by the ARC, as the case may be, and not creating, declaring, assigning, limiting or extinguishing any right, title or interest to or in immovable property except in so far as it entitles the holder of the security receipt to an undivided interest afforded by a registered instrument; or (b) No compulsory registration require for any transfer of security receipts.

Registration

- The RBI play important role on the registration and certificate of registration as provided in SARFAESI Act;
- The activities of securitization and asset reconstruction taken by the ARC Company after the obtaining of certificate of registration by the RBI.
- If any entity not registered with RBI under SARFAESI Act may conduct the business of securitization or asset reconstruction outside the purview of the Act.

Procedure for Enforcement of Rights

(i) According to Section 13 (2), a notice for the 60 days is giving to the borrower for setting the liability and also inform about his intention to the secured creditor to take action under section 13(4) by taking possession of the assets. (ii) if within the 60 days of the notice amount due is not paid by the borrower than the bank can seize the assets and bring it for sale to realize the dues. (iii) The borrower have right to seek any clarification from the bank and it is the duty of the bank to answer the queries within 7 days of such request. (iv) the Act also gives opportunity to the borrowers to get whatever details he requires from the creditor like the amount due, interest claimed etc. if there are mistakes in the notice, the creditor can issue a fresh notice. However, after the reasons so communicated by the secured creditor than the borrowers have no confer any right to prefer an application to the DRT. (v) The notice can be issued only by an ‘Authoized Officer’ of the bank who will be an official in the rank of Scale IV and above under the Securitization Act 2002. After taking possession on the Asset, the bank has to publish a possession notice in two newspapers for the information of the general public. (vi) Such publication notice is to be made within 7 days of taking the possession of the property. The borrower can also approach DRT for grievances if any, within 45 days of taking possession by the bank. Any party who agrees with the decision of the DRT can again
approach the DRAT by filing appeal within the time of 30 days. (vii) After obtaining the valuation of property through Government approved value the possession property can be sold and there after publishing the sale notice in two newspapers (one in the vernacular) giving 30 days notice. Thus the property can be sold for maximum price with wide publicity. Any excess amount realized is not sufficient to cover the dues; the secured creditor can approach the DRT to recover the balance amount.

**Protection of Borrowers' rights**

The borrowers can remit the dues and avoid loosing the security at any time before the sale is concluded. He will also liable for penal consequences in case of any illegal act done by the officers. The borrowers will be entitled to get compensation for such acts. The borrowers can approach, firstly the DRT but now he directly go with the securitization Act in appeal for redressing the grievances. The period for the appeal is limited up to 45 days and 30 days respectively.

**Conclusion**

The level of non-performing assets directly affects the profitability, productivity, liquidity and equity of banks. It also affects the credit system of the banks. There are many factors which increased the level of the NPAs. With the introduction of economic reforms in the year 1991, many measures were introduced by the RBI and banking industry to improve the credit management process and recovery of NPA accounts. The NPA is the main indicator to assess the financial performance of banks. The financial crisis that erupted worldwide has impacted the quality of asset portfolio and result into higher NPA. The increase in NPA since 2007-08 is an area of concern for regulatory authorities and commercial banks. It hence requires a detailed analysis of the NPA in the post millennium period to assess the trend in the movement of NPA and a critical evaluation based on expert feedback to critically analyze whether the NPA management is effective in Indian scheduled commercial banks. Despite various corrective measures, if upgradation is not proving to be possible due to the unviable nature of the borrowers’ business, the bank should take steps to recover the loans through any of the recovery options available to them. The enactment of the securitization Act 2002 is very helpful in the recovery of the NPAs and credit management. The Main feature of the Act is that no need to go court.
Keeping in mind the above views & importance of the Act, a modest attempt made to carry out study in respect of impact of SRAFAESI Act 2002 in NPAs of Indian public sector banks. This study intends to examine the impact of SARFAESI Act 2002 on the recovery rate of the NPAs and performance of Indian public sector banks.