CHAPTER -V
SARFAESI ACT ON INDIAN BANKING INDUSTRY
THE SECURITISATION AND RECONSTRUCTION OF FINANCIAL
ASSETS AND ENFORCEMENT OF SECURITY INTEREST ACT, 2002.

SARFAESI Act enacted by parliament in the 53rd year of the Republic of India – as follows:

LEGISLATIVE HISTORY

The Act replaces the ordinance by the same name promulgated by the President on 21st June 2002. The ordinance was repromulgated by the President on 21st August 2002. The ordinance contained a merged version of two separate Bills on securitization, and enforcement of security interests earlier drafted at the behest of the Andhyarijuna Committee.

Between the date of promulgation of the ordinance and the presentation of the Bill in the parliament, there was substantial scope for improving upon the loose language of this important piece of law, but the Government did not utilize the opportunity, and the Bill was almost as verbatim the same as the ordinance.

The Bill was presented before the Lok Sabha on 21st Nov. 2002 and before the Rajya Sabha on 25th Nov. 2002.

Record of debate in the Lok Sabha indicates that the members were concerned about the ordinance route adopted by the Government. The finance minister agreed with “all the hon. members who say that recourse to the path of ordinance is not a good path”. The finance minister went on to say as follows:

“This Bill is essentially for securitization of financial assets so as to generate immediate liquidity and it is also to enforce securitization because at the present moment, there are no powers. The commercial environment both within the country as also globally, is changing. This results in what I would call on asset-liability mismatch as well as in mounting levels of non performing assets (NPAs). As a ratio of GDP,
Indias NPAs are really much lower than some of the countries. The Government is committed to constantly reviewing, constantly improving the provisions.

We believe that a climate has to be created within the country so that there is a sense of responsibility created, both in the borrower as also the lender. As far as big borrowers are concerned definitely action will be taken against them and as far as the small borrowers are concerned the Government is not going to discriminate against them too.

We have to act without fear and favour and finance ministry acts only in the interest of the country. I also want to make it clear that the state financial corporations will also be covered under the provisions of this Bill. I wish to assure the hon. members that employees will not be affected with this change and no employee, either in the management or a worker, will be affected on this account. The rules have already been notified under the ordinance and the Reserve Bank of India is already in the process of issuing guidelines. I wish to make it clear that if between the lender and the borrower if there is any third party involved, then that third party can always approach a court of law.

Out of the 27 public sector banks, during the pendency of the ordinance, 25 banks have issued notices in respect of about 10,000 odd borrower’s accounts. The banks have reported that there is a positive impact of the ordinance and some borrowers have approached for a compromise or a negotiated settlement. Just as the borrower has the responsibility, it is the collective view of the Government that the lender also has the responsibility. We must now recognize that whereas the borrower has the responsibility and obligation, which is both commercial and moral to repay what he borrowed, the lender has an obligation to continue to service the borrower positively, supportively and not always as if the two are combative halves of a different organization. It is for this and various other reasons that I commend this bill for the consideration of the House.

This act extends to the whole of India. It shall be deemed to have come into force on the 21st day of June, 2002’.”
SCOPE OF THE LAW

THREE-IN-ONE

This Act merges into one three separate, and far most parts, unrelated pieces of draft legislation. These three parts are: (a) Securitization; (b) Setting up of asset reconstruction companies; and (c) Provisions relating to registration and enforcement of security interests.

There is an element of commonality, as well as confusion that has resulted from the fusion of these three elements into a single piece of legislation. For example, the requirements for asset reconstruction companies have been applied to securitization companies as well.

Provisions for registration of security interests have also been made applicable to transfers in connection with securitization, and provisions which ought to have excluded the applicability of the security interest matters have apparently eluded securitization and reconstruction transactions as well.

If one looks at the legislative history it is evident that the purposes of the three elements of the present law were discernibly distinct.

- Securitization is related to conversion of financial assets into capital market securities which is, for most purposes, unconnected with resolution of non-performing assets. The purpose of law-making in this field could not have been but enabling, to iron out difficulties created by common law.

- Asset reconstruction companies, or asset management companies as they are globally called, exist for a distinct purpose-acquisition and resolution of sticky debts. Such companies have in number of countries, also securitised their assets but their primary motive is not securitization but resolution. The purpose of law making here was to confer special powers to enable ARCs to recover non – performing loans.

- Enforcement of security interests is apparently completely unconnected and it is very difficult to understand the purpose of clubbing this along with the above two elements- except probably, the political convenience of giving this important change in law the garb of being related to securitization and
reconstruction and thus making it easy to ‘push through’ as something technical and hence, politically insensitive.

**OBJECT OF THE LEGISLATION:**

- **Enabling statute:** is one which confers a new right that was not available more than through such statute. For example, the Companies Act is an enabling legislation – as formation of companies is enabled by this law.

- **Regulatory statute:** A number of laws intend to regulate something which warranted government’s control. The Banking Companies Regulation Act or the Securities Contracts (Regulation) Act are quick examples. More than giving any new power, they seek to curb the powers that existed otherwise. Regulatory statutes are often also classed as mandatory, declaratory, remedial, etc.

- **Penal statute:** As the name implies, these laws seek to penalize a wrong-Most criminal laws, TA DA are examples of penal laws.

- **Fiscal statute:** Statutes to allow the Government to raise revenue.

It is quite obvious that the objective of the present statute, in respect of each of the three matter it deals with, could not have been anything but enabling. The question of regulation arises when something exists and is unregulated and the object of the legislation is to regulate the activity. Asset reconstruction activity will, hopefully originate by virtue of this law. Enforcement of security interests is intended to be given a new perspective-a new power, by virtue of this law. Securitization activity was existing in some measure even without this law, but obviously the purpose of the Government was to obviate the difficulties being faced by such transactions, rather than to address any lack of discipline in the securitization market.

Unfortunately, however, the regulators idea of a gift is that he takes away more than he gives. That is certainly true in the context of securitisation. Securitization activity was going on the country even in absence of this law. However, market players were faced with certain difficulties on account of lack of proper legal provisions. Therefore, it was thought necessary to iron out difficulties and remove bottlenecks. The over-riding purpose of the legislation was to remove
difficulties, rather than to create discipline. However, the over-riding idea of the present statute seems to be regulation – complete with licensing, conditions of license, cancellation, appeals and penalties.

OPERATION OF THE LAW

From the viewpoint of the subject matter of the law, this combo piece of legislation should appropriately fall into the category of statutes relating to contracts and transfer of properties. It either provides for certain formalities relating to transfer of properties or dispenses with certain formalities on transfer of-in relation to both securitization and reconstruction companies.

In terms of the age – old rule of interpretation, such provisions usually have a prospective application. Such statutes usually do not apply to transfers that were effected prior to their enactment. Transfers made prior to the operative date of the law can neither take the benefit of the law, nor can be subjected to the burdens of the law. Such was the interpretation of the Provisions of Transfer of Property Act [Ahmad Razav. Abid Hussin].

In case of enforcement of security interests, the scope of operation of the new law would be more curious. The provisions relating to creation of security interests can be said to be declaratory in nature, they intend to create a prospective benefit to something done in the past. In other words, the law intends to provide a new remedy for something which already has some remedy, however, found ineffective. In such cases, the rule against retrospective legislation does not apply – that is to say, remedial measures can be applied even to things which have been done in the past.

In other words, it is not necessary for enforcement of security interests under the new legislation that the security interest must have been created after the law came into force, Definitions (1) in this Act, unless the content otherwise requires:-

(A)“Appellate Tribunal” means a Debts Recovery Appellate Tribunal established under sub-section (1) of section 8 of the Recovery of debts due to Banks and Financial Institutions Act, 1993 (51 of 1993).
(B) “Asset Reconstruction” means acquisition by any securitisation company or reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realization of such financial assistance.

A short history of the word “Asset Reconstruction”: In global banking jargon, the word “asset reconstruction” is not commonly used. The more common word is “asset management” or “resolution”. There is a brief history as to how the internationally – prevalent word “asset management companies” changed to “asset reconstruction companies” in India.

There was a proposal in the Narasimham Committee I to set up an “asset reconstruction fund” supported by the Government into which assets of banks with high NPAs will be transferred. By the time of Narasimham II, a lot of international activity had already been seen in resolution of NPAs in several Asian countries. Therefore, Narasimham II recommended setting up of resolution companies on the lines of what had been done in Asia. These companies, in the earlier time, were called Asset Reconstruction Companies.

The Budget 1999-2000 announced the decision of the Government to set up an ARC on a pilot basis for which the modalities were to be worked out. Since then, the ARC proposal has been a permanent fixture on each union Budget, and it is only after more than 3 years that legislative steps have been taken to enable formation of ARCs.

Till very recently, it appears that the Government was not certain about the exact mechanism of ARCs. As recently as in April 2002, RBI Deputy Governor G.P. Muniappan said in a CII meeting in Mumbai on April 1, 2002:“An Asset Reconstruction company with an authorized capital of Rs.2,000 crore and initial paid up capital Rs.1,400 crore is to be set up as a trust for undertaking activities relating to asset reconstruction. It would negotiate with banks and financial institutions for acquiring distressed assets and develop markets for such assets. Government of India proposes to go in for legal reforms to facilitate the functioning of ARC mechanism”. The Deputy Governor was clearly hinting at one ARC for several banks, and that too,
in a trust format, while the theme of the present legislation seems to be separate ARCs for separate banks, in a corporate format.

( C ) “Default” means non-payment of any principal debt or interest there on or any other amount payable by a borrower to any secured creditor consequent upon which the account of such borrower is classified as non-performing asset in the books of account of the secured creditor in accordance with the directions or guidelines issued by the Reserve Bank.

**NPA classification in case of banks:**

The RBI’s existing policy on NPA classification is given by the following prudential norms.

An asset, including a leased asset becomes non-performing when it ceases to generate income for the bank. A ‘non- performing asset’ (NPA) was defined as a credit facility in respect of which the interest and / or instalment of principal has remained ‘past due’ for a specified period of time. The specified period was reduced in a phased manner as under:

<table>
<thead>
<tr>
<th>Year ending March 31</th>
<th>Specified period</th>
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<tbody>
<tr>
<td>1993</td>
<td>Four quarters</td>
</tr>
<tr>
<td>1994</td>
<td>Three quarters</td>
</tr>
<tr>
<td>1995 Onwards</td>
<td>Two quarters</td>
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The following are the extracts from an RBI publication titled Banking Developments and Policy Perspectives 1998-99.

To address the problem of accumulated NPAs, the first Narasimham Committee suggested the setting up of an Asset Reconstruction Fund, but this suggestion could not be implemented. Reiterating this arrangement, the second Narasimham Committee suggested the setting up of an Asset Reconstruction Company (ARC). The ARC, which would take over all loan assets in the doubtful and loss categories, would issue to the banks NPA swap bonds representing the realizable value of the assets transferred, provided the stamp duties are not excessive.
The international experience with such arrangements has, however, been mixed. In India, progress in setting up of ARCs, is yet to be seen partly because the Debt Recovery Act and other relevant legislations are yet to be strengthened. Besides, the ARCs could engender moral hazard problems. It is, therefore, necessary to attempt to make Debt Recovery Tribunals (DRTs) more effective in their operation. More importantly, Debt Recovery Systems need to be improved across the board to ensure efficiency of the financial sector.

(D) “Debts Recovery Tribunal” means the tribunal established under subsection (1) of section 3 of the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (51 of 1993).

DEFAULT IN CONNECTION WITH THE NPA GUIDELINES OF THE RBI

The definition of default has been connected in this definition with the NPA treatment as per the directions or guidelines of the RBI. The RBI has issued guidelines for NPA classification for banks, as also for non-banking financial institutions. There are numerous differences between the NPA definition applicable to finance companies and banks. Therefore, the appropriate NPA guidelines need to be applied to see if the contract has become an NPA.

ELEMENTS OF DEFAULT

There are 4 important elements for establishing a default under this definition:

(a) The borrower must be a “borrower” within the definition of this legislation. The definition of borrower is connected with two other definitions – financial assistance, and bank / financial institution. In other words, the counterparties to the financial assistance must be a borrower on the one hand and a bank or financial institutions on the other, and the relation that connects the two should be one of a financial assistance.

(b) The financial assistance must be secured.

(c) There must have been a non-payment of principal, interest or any other sum payable by the borrower. For example, a borrower may have been called upon to pay inspection charges, service charges or such other sums. The issue is, Can there be a “default”. The default must be such which can render the account an NPA. In terms of the NPA guidelines applicable to both banks
and non-banking financial institutions, an account is not treated as an NPA except on account of default of interest or principal.

(d) The definition of NPA is not related to the magnitude of the default, but its length. So, if the default has continued for a period which renders the account of the borrower an NPA, the borrower can be said to be have defaulted. NPA classification, under the RBI norms, leads to de-recognition of income and cessation of accrual – which is an accounting event. There is an accounting dimension of an NPA classification. In accordance with the directions or guidelines issued by the Reserve Bank implies that the NPA classification is based on the RBI directives.

A number of banks, particularly international banks have stricter internal NPA recognition norms. Several international lending agencies also require NPAs to be recorded based on a shorter time-frame of default than under the RBI norms. However, for the purpose of recognizing a “default” under this definition, it is only a default as per the RBI directives. A lender cannot narrow down the period of “default” by any of his own internal procedures for recognizing a default.

(E) “Financial asset” means debt or receivables and includes;

(i) a claim to any debt or receivables or part there of whether secured or unsecured; or
(ii) any debt or receivables secured by, mortgage of, or charge on, immovable property; or
(iii) a mortgage, charge, hypothecation or pledge of movable property; or
(iv) any right or interest in the security, whether full or part underlying such debt or receivables; or
(v) any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent; or
(vi) any financial assistance.

(F) **Accounting standards:**

Accounting standards contain the definition of “financial assets” as the accounting standards on accounting for financial instruments relate to financial assets
and financial liabilities. A financial asset is thus defined under IAS 39: “A financial asset” is any asset that is:

(i) cash,
(ii) a contractual right to receive cash or another financial asset from another enterprise,
(iii) A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable.
(iv) An equity instrument of another enterprise.

(G) “Reconstruction Company”: Reconstruction company means a company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of asset reconstruction.

(H) “Reserve Bank”: Reserve Bank means the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934 (2 of 1934).

(I) “Scheme”: Scheme means a scheme inviting subscription to security receipts proposed to be issued by a securitization company or reconstruction company under that scheme.

(J) “Securitisation”: Securitisation means acquisition of financial assets by any securitization company or reconstruction company from any originator, whether by raising of funds by such securitization company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise.

The central feature of securitization is therefore, the fact there is a segregation of assets and issuance of securities which are either collateralized by such assets or represent beneficial interest in such assets.

There are several cases where there is a segregation of assets, but there is no creation of securities -, for example if A transfers financial assets to B, that is the end of the story. B’s acquiring financial asset is not securitization – it is a loan or portfolio transfer. A securitization implies creation of securities premised on such
assets – because the central theme in securitization is the conversion of a financial relation into a financial product, viz, a security.

**ENFORCEMENT OF SECURITY INTEREST**

Enforcement of security interest: Notwithstanding anything contained in section 69 or section 69A of the Transfer of property Act, 1882 (4 of 1882), any security interest created in favour of any secured creditor may be enforced, without the intervention of court or tribunal, by such creditor in accordance with the provisions of this Act.

1. Where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt or any instalment thereof, and his account in respect of such debt is classified by the secured creditor as non-performing asset, then the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor shall be entitled to exercise all or any of the rights under sub-section (4). The notice referred to in sub-section(2) shall give details of the amount payable by the borrower and the secured assets intended to be enforced by the secured creditor in the event of non-payment of secured debts by the borrower.

2. In case the borrower fails to discharge his liability in full within the period specified in sub-section (2), the secured creditor may take recourse to one or more of the following measures to recover his secured debt, namely:

   a) Take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realizing the secured asset;

   b) Take over the management of secured assets of the borrower including right to transfer by way of lease, assignment or sale and realize the secured asset;

   c) Appoint any person (hereafter referred as the manager), to manage the secured assets the possession of which has been taken over by the secured creditor;
d) Require at any time by notice in writing, any person who has acquired any of
the secured asset from the borrower and from whom any money is due or may
become due to the borrower, to pay the secured creditor, so much of the
money as is sufficient to pay the secured debt.

3. Any payment made by any person referred to in clause (d) of sub-section (4) to
the secured creditor shall give such person a valid discharge as if he has made
payment to the borrower.

4. Any transfer of secured asset after taking possession there of or take over of
management, under sub-section (4), by the secured creditor or by the manager on
behalf of the secured creditors shall vest in the transferee all rights in or in
relation to the secured asset transferred as if the transfer had been made by the
owner of the secured asset.

5. Where any action has been taken against a borrower under the provisions of sub-
section (4), all costs, charges and expenses which, in the opinion of the secured
creditors, have been properly incurred by him or any expenses incidental thereto,
shall be recoverable from that borrower and the money which is received by the
secured creditor shall, in the absence of any contract to the contrary, be held by
him in trust to be applied, firstly, in payment of such costs, charges and expenses
and secondly, in discharge of the dues of the secured creditor and the residue of
the money so received shall be paid to the person entitled thereto in accordance
with his rights and interests.

6. If the dues of the secured creditor together with all costs, charges and expenses
incurred by him are tendered to the secured creditor at any time before the date
fixed for sale or transfer, that secured asset shall not be sold or transferred by the
secured creditor, and no further step shall be taken by him for transfer or sale of
that secured asset.

7. In the case of financing of a financial asset by more than one secured creditors or
joint financing of a financial asset by secured creditors, no secured creditor shall
be entitled to excise any or all of the rights conferred on him under or pursuant to
sub-section (4) unless exercise of such right is agreed upon by the secured
creditors representing not less than three-fourth in value of the amount outstanding as on a record date and such action shall be binding on all the secured creditors:

Provided that in the case of a company in liquidation, the amount realized from the sale of secured asset shall be distributed in accordance with the provisions of section 529A of the Companies Act, 1956 (1 of 1956);

Provided further that in the case of a company being wound up on or after the commencement of this Act, the secured creditor of such company, who opts to realise his security instead of relinquishing his security and proving his debt under provision to sub-section (1) of section 529 of the Companies Act, 1956 (1 of 1956), may retain the sale proceeds of his secured assets after depositing the workmen’s dues with the liquidator in accordance with the provisions of section 529A of that Act;

Provided also that the liquidator referred to second provision shall intimate that secured creditor the workmen’s dues in accordance with the provisions of section 529A of the Companies Act, 1956 (1 of 1956), and in case such workmen’s dues cannot be ascertained, the liquidator shall intimate the estimated amount of workmen’s dues under that section to the secured creditor and in such case, the secured creditor may retain the sale proceeds of the secured asset after depositing the amount of such estimated dues with the liquidator;

Provided also that in case the secured creditor deposits the estimated amount of workmen’s dues, such creditor shall be liable to pay the balance of the workmen’s dues or entitled to receive the excess amount, if any deposited by the secured creditor with the liquidator;

Provided also that the secured creditor shall furnish an undertaking to the liquidator to pay the balance of the workmen’s dues, if any.

a) “record date” means the date agreed upon by the secured creditors representing not less than three fourth in value of the amount outstanding on such date;
b) “amount outstanding” shall include principal, interest and any other dues payable by the borrower to the secured creditor in respect of secured asset as per the books of account of the secured creditor.

8. Where dues of the secured creditor are not fully satisfied with the sale proceeds of the secured assets, the secured creditor may file an application in the form and manner as may be prescribed to the Debts Recovery Tribunal having jurisdiction or a competent court, as the case may be, for recovery of the balance amount from the borrower.

9. Without prejudice to the rights conferred on the secured creditor under or by this section, secured creditor shall be entitled to 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 (4) in relation to the secured creditor’s assets under this Act.

10. The rights of secured creditor under this Act may be exercised by one or more of his officers authorized in this behalf in such manner as may be prescribed.

11. No borrower shall, after receipt of notice referred to in sub-section (2), transfer by way of sale, lease or otherwise (other than in the ordinary course of his business) any of his secured assets referred to in the notice, without prior written consent of secured creditor.

12. Chief metropolitan magistrate or District magistrate to assist secured creditor in taking possession of secured asset:

   (1) where the possession of any secured asset is required to be taken by the secured creditor or if any of the secured assets is required to be sold or transferred by the secured creditor under the provisions of this Act, the secured creditor may, for the purpose of taking possession or control of any such secured asset, request, in writing, the chief metropolitan magistrate, or the district magistrate within whose jurisdiction any such secured asset or other documents relating thereto may be situated or found, to take possession thereof, and the chief metropolitan magistrate or as the case may be, the district magistrate shall, on such request being made to him –
a) Take possession of such asset and documents relating thereto; and

b) Forward such asset and documents to the secured creditors.

(2) For the purpose of securing compliance with the provisions of sub-section (1), the chief metropolitan magistrate or the district magistrate make take or cause to be taken such steps and use, or cause to be used such force, as may, in his opinion, be necessary.

(3) No act of the chief metropolitan magistrate or the district magistrate done in pursuance of this section shall be called in question in any court or before any authority.

13. Manner and effect of take over of management:

(1) When the management of business of a borrower is taken over by the secured creditor, the secured creditor may, by publishing a notice in a newspaper published in English language and in a newspaper published in an Indian language in circulation in the place where the principal office of the borrower is situated, appoint as many persons as it think fit –

   (a) In case where the borrower is a company as defined in the Companies Act, 1956 (1 of 1956), to be the directors of that borrower in accordance with the provisions of that Act; or

   (b) In any other case, to be the administrator of the business of the borrower.

(2) On publication of a notice under sub-section (1)-

   a) In any case where the borrower is a company as defined in the Companies Act, 1956 (1 of 1956), all persons holding offices as directors of the company and in any other case, all persons holding any office having power of superintendence, direction and control of the business of the borrower immediately before the publication of the notice under sub-section (1), shall be deemed to have vacated their offices as such;
b) Any contract of management between the borrower and any director or manager thereof holding office as such immediately before publication of the notice under sub-section (1), shall be deemed to be terminated;

c) The directors or the administrators appointed under this section shall take such step as may be necessary to take into their custody or under their control all the property effects and auctionable claims to which the business of the borrower is, or appears to be, entitled and all the property and effects of the business of the borrower shall be deemed to be in the custody of the directors or administrators, as the case may be, as from the date of the publication of the notice;

d) The directors appointed under this section shall, for all purposes, be the directors of the company of the borrower and such directors or as the case may be, the administrators appointed under this section, shall alone be entitled to exercise all the powers of the directors or as the case may be, of the persons exercising powers of superintendence, direction, and control, of the business of the borrower whether such powers are derived from the Memorandum or Articles of Association of the company of the borrower or from any other source whatsoever.

(3) Where the management of the business of a borrower, being a company as defined in the Companies Act, 1956 (1 of 1956), is taken over by the secured creditor, then, not withstanding anything contained in the said Act, or in the memorandum or articles of association of such borrower –

a) It shall not be lawful for the shareholders of such company or any other person to nominate or appoint any person to be a director of the company;

b) No resolution passed at any meeting of the shareholders of such company shall be given effect to unless approved by the secured creditor;
c) No proceeding for the winding up of such company or for the appointment of a receiver in respect thereof shall lie in any court, except with the consent of the secured creditor.

(4) Where the management of the business of a borrower had been taken over by the secured creditor, the secured creditor shall, on realization of his debt in full, restore the management of the business of the borrower to him.

14. No compensation to directors for loss of office:

(1) Notwithstanding anything to the contrary contained in any contract or in any other law for the time being in force, no managing director or any other director or a manager or any person in charge of management of the business of the borrower shall be entitled to any compensation for the loss of office or for the premature termination under this Act of any contract of management entered into by him with the borrower.

(2) Nothing contained in sub-section (1) shall affect the right of any such managing director or any other director or manager or any such person in charge of management to recover from the business of the borrower, moneys recoverable otherwise than by way of such compensation.

15. (1) Right to appeal; any person (including borrower) aggrieved by any of the measures referred to in sub-section (4) of section 13 taken by the secured creditor or his authorized officer, may prefer an appeal to the Debts Recovery Tribunal having jurisdiction in the matter within forty-five days from the date on which such measures had been taken.

(2) Where an appeal is preferred by a borrower, such appeal shall not be entertained by the Debts Recovery Tribunal unless the borrower has deposited with the Debts Recovery Tribunal seventy-five percent of the amount claimed in the notice referred in sub-section (2) of section 13: provided that the Debts Recovery Tribunal may, for reasons to be recorded in writing, waive or reduce the amount to be deposited under this section.
(3) save as otherwise provided in this Act, the Debts Recovery Tribunal shall, as far as may be, dispose of the appeal in accordance with the provisions of the Recovery of Debts due to Bank and Financial Institutions Act, 1993 (51 of 1993) and rules made thereunder.

16. Appeal to Appellate Tribunal:

(1) Any person aggrieved by any order made by the Debts Recovery Tribunal under section 17 may prefer an appeal to an Appellate Tribunal within thirty days from the date of receipt of the order of Debts Recovery Tribunal.

(2) Save as otherwise provided in this Act, the Appellate Tribunal shall, as far as may be, dispose of the appeal in accordance with the provisions of the recovery of debts due to Banks and Financial Institution Act, 1993 (51 of 1993) and rules made thereunder.

17. Right of the borrower to receive compensation and costs in certain cases if the Debts Recovery Tribunal or the Appellate Tribunal, as the case may be, on an appeal filed under section 17 or section 18, holds the possession of secured assets by the secured creditor as wrongful and directs the secured creditor to return such secured assets to the concerned borrower, such borrower shall be entitled to payment of such compensation and costs as may be determined by such Tribunal or Appellate Tribunal.

Salient Features of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002:

While the banking industry in India is progressively complying with the international prudential norms and accounting practices, there are certain areas in which the banking and financial sector do not have a level playing field as compared to other participants in the financial markets in the world.

Acting on the suggestions of Narasimham Committee I and II and Andhyarujina Committee constituted by the Central Government for the purpose of examining banking sector reforms, a new legislation for securitization and empowering banks and financial institutions to take possession of the securities and
to sell them without the intervention of the court, was enacted. The Securitization and Reconstruction of Financial Assets and Enforcement of Interest Ordinance, 2002 was promulgated on the 21st June, 2002 to regulate securitization and reconstruction of financial assets and enforcement of security interest matters connected therewith or incidental thereto the ordinance, which enable and financial institutions to realise an asset, manage problem of liquidity, liability mismatches and improve by exercising powers to take possession of securities, sell them and reduce non-performing assets by adopting measures recovery or reconstruction, has now replaced by an Act.

The Central Government had promulgated an ordinance called “The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002” (securitisation ordinance) on 21/06/2002. Government had also introduced a bill to this effect in the Parliament during the last monsoon session but the same could not be taken up for discussion due to several factors including disturbances in the Parliament proceedings. Thereafter to keep its continuity, the Government had to re-promulgate this ordinance, which has since been passed by the Parliament. It received the assent of the President on 17/12/2002 and has now become an Act. The securitization ordinance was up the debt recovery process of banks, institutions by attachment of their assets to obtain a decree through normal legal competent court of law. Although had a mixed reaction after the ordinance, one of the reasons for which cured with the ordinance was that make any difference between the normal business defaulters. The various factors including the economic country for the last couple of years made banks and financial institutions beyond their control but as per the Central Government an estimated amount of about Rs. 1 lakh into Non-Performing Assets (NPAs).

Banks, Financial institutions, and committees after committees have recommended introduction of such kind of law which will provide faster mechanism to the lenders to recover their dues and to be able to not only attach the assets of the defaulters but also to encash them. The present law does not provide such a relief and it was taking a very long time in realization of dues, which was detrimental to public interest and affected national growth. With this back-ground, the Central Government has brought in the securitization law and this has sent right signals not only to the defaulters concerned but also Reserve Bank of India Act, 193 Government may specify for the Act.
Strengthening the commercial banking system

Capital adequacy measures:

Capital constitutes the basic cushion as a rescue for contingencies. The Basel Committee on Banking Supervision (BCBS) had released a consultative paper on new Capital Adequacy framework in June 1999 to further strengthen the soundness of the financial system and better align regulatory capital with the underlying risks faced by banks. Recognising the implications of the new framework on emerging market economies like India, the Reserve Bank constituted an internal working group to examine the impact, applicability, scope, problems and the time span of its implementation in India. The Reserve Bank has finalized its views on the basis of the recommendations of the group, and subsequently forwarded its comments to the Basel Committee. The main thrust of the comments is to ensure sufficient flexibility in the framework to fully reflect the macro-economic environment, structural rigidities and concerns of Emerging Markets. The Reserve Bank felt that where banks are of simple structure and have subsidiaries, the framework could be adopted on stand-alone basis with the full deduction of equity contribution made to subsidiaries from the total capital. Besides national supervisor should have discretion to prescribe a material limit up to which cross-holdings could be permitted. Moreover, the Reserve Bank felt that assigning greater role to external rating agencies in regulatory process would not be desirable. Instead domestic credit rating agencies, which are more adequately informed, would be more effective, subject to adequate safeguards. Further, the Reserve bank viewed that risk weights of banks ought to be de-linked from that of the sovereign. Instead, preferential risk weights in the range of 20-50 percent, on a graded scale may have to be assigned on the basis of risk assessments by domestic rating agencies. Furthermore, the proposal for assigning favourable risk weight to short term claims would jeopardize the stability of the international financial architecture. Again, the proposal to link the banking supervisor implementing / endorsing the core principles for effective banking supervision was not considered desirable. Finally, while the committee’s views on increased disclosures and enhanced transparency are reasonable, national supervisors should consider the ability of the market to logically interpret the information.

The new capital adequacy norms proposed by the BCBS in June 1999 if implemented, are likely to be stricter than those prevailing at present. The new norms
with its explicit emphasis on ratings, internal and external, are likely to have implications for the required levels of capital.

Ratings of Banks:

The Basel Committee on Banking Supervision (BCBS) has proposed a revised Capital Adequacy framework in 1999, which uses a three-pillar approach consisting of (a) a minimum capital requirements pillar, (b) a supervisory review pillar to ensure that the bank’s capital is aligned to its actual risk profile, and (c) a market discipline pillar to enhance the role of the other market participants in ensuring that appropriate capital is held by prescribing greater disclosure. The revised framework is presently being discussed by supervisory authorities all over the world.

The revised framework places an explicit emphasis on ratings. Risk differentiation between counter parties, be they sovereign governments, banks, corporates, public sector enterprises or securities firms is sought to be done either on the basis of external or internal ratings. In broad summary, the weights based on external risk assessment proposed for claims on sovereign governments, banks and corporates are presented in Table.

### Proposed Risk weights based on External Risk Assessment

<table>
<thead>
<tr>
<th>Assessment</th>
<th>Claim on Sovereign</th>
<th>Banks Option 1</th>
<th>Banks Option 2</th>
<th>Corporates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Governments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>AAA to AA-</td>
<td>0</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>A+ to A-</td>
<td>20</td>
<td>50</td>
<td>50*</td>
<td>100</td>
</tr>
<tr>
<td>BBB+ to BBB-</td>
<td>50</td>
<td>100</td>
<td>50*</td>
<td>100</td>
</tr>
<tr>
<td>BB+ to B-</td>
<td>100</td>
<td>100</td>
<td>100*</td>
<td>100</td>
</tr>
<tr>
<td>Below B-</td>
<td>150</td>
<td>150</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Unrated</td>
<td>100</td>
<td>100</td>
<td>50*</td>
<td>100</td>
</tr>
</tbody>
</table>

* Claims on banks of short-term maturity, e.g. less than 6 months would receive a weighting that is one category more favourable than the usual risk weight on the bank’s claim.

Option 1: Based on risk weight of sovereign where Bank is incorporated.

Option 2: Based on assessment of the Individual Bank.
The Reserve Bank, however, favoured greater reliance on internal ratings-based approach for banks, which could be structured under an acceptable framework so that a standardized approach to internal rating could be adopted. The internal ratings-based approach could incorporate supplementary customer information, which is typically not available to credit assessment institutions. It could also extend to a greater number of counter-parties, such as, unrated borrowers in the small/retail sector. This would encourage banks to refine their risk assessment and monitoring process, which would facilitate better management of their loan books. The regulators should, however, evolve suitable process and criteria for approving the rating framework so as to ensure the integrity of different banks’ systems and that the parameters are consistent across various institutions.

The level of NPAs of the banking system in India has shown an improvement in recent years, but it still remains high. A significant part of the problem arises on account of the carry-over of old NPAs in certain sunset industries. The problem is often complicated by the fact that there are a few banks which are fundamentally weak and where the potential for return to profitability; without substantial restructuring, is doubtful. The resolution of the NPA problem requires greater accountability on the part of corporate greater disclosures in the case of defaults, and an efficient Credit Information System. Action has been initiated in all these areas, and it is expected that, with the help of stricter accounting and prudential standards and appropriate legal support, NPAs will be effectively contained.

The problem of NPAs is closely tied to the issue of legal reforms. Recognising that the legal framework pertaining to the banking system might act as an impediment to its efficient functioning, initiatives have been taken to align the legal set up with the requirements of the banking system. The legal framework is a key ingredient for limiting moral hazard. Given the high transactions costs of finality of settlement, including legal costs, there is an urgent need for developing workable laws on contract, collateral and bankruptcy proceedings and to implement and streamline court procedures for seeking effective and rapid remedies under these laws. The issues would assume greater importance as economic liberalization gathers momentum. Otherwise, the continual state of innovation and evolution of new financial products in the liberalization process would outpace the existing legislation and raise the need for implementing fine and sharper points of law. It is, therefore, essential that the requisite legal framework is quickly put in place.
In India, the issues pertaining to legal framework have been examined by the
Expert group under the chairmanship of Shri T.R. Andhyarujuna, former solicitor
General of India. The Group, in its Report submitted in February 2000 to the
Government recommended, among other things, the creation of a new law granting
statutory power of possession and sale of security directly to banks and FIs and
adoption of the draft securitization Bill. It has also suggested the provision of
additional avenues of recovery of dues to banks and FIs by empowering them to take
possession of securities and sell them for recovery of loans.

SECURITISATION

A prominent development in international finance in recent years has been the
growing importance of securitization. Securitisation can be best described as
structured financing in which assets, having a stable and predictable stream of cash
payments, can be monetized through a public offering or private placement of
securities in the capital markets and which are secured by, and dependent in part
upon, the assets securitized and their related cash flows. In effect, securitization is a
combination of traditional secured financing and securities offering, involving the
issuance of asset-backed securities. Virtually every asset that has a predictable
stream of cash payments could be securitized.

The Reserve Bank, considering the evolving situation in this area and the
need for reducing risks for the banks, appointed an in-house working Group on Asset
securitization (Chairman : Shri V.S.N. Murty) in June 1999 to examine the
applicability of securitization to the Indian financial system. The Group, in its Report
submitted in December 1999, categorized the recommendations into short-term,
medium-term and long-term, with a definite time frame for implementation in each
category. It suggested that securitization should be appropriately defined to lend
uniformity of approach and restrict the benefits provided by law/ regulation for
genuine securitization transactions. The recommendations also include
rationalization/reduction of stamp duties, inclusion of securitized instruments in
securities contracts (Regulation) Act, 1956, removal of prohibition on investment in
mortgaged-backed securities by mutual fund schemes.
Securitisation involves the process of pooling and repackaging of homogeneous illiquid loans into marketable securities and distributing to a broad range of investors through capital markets. In the process, the lending institutions’ assets are removed from its balance sheet and are instead funded by investors through a negotiable financial instrument. Increased pressure on operating efficiency market niches, competitive advantages, and capital strength provide impetus for change. Securitisation has emerged as one of the solutions to these challenges.

Although relatively new in European and other countries, asset securitization as a structured financing technique had its genesis in the US in the late ‘seventies’. Securitisation evolved rapidly throughout the ‘eighties’ and ‘nineties’ to become one of the dominant means of capital formation. As of 1995, securitization accounted for more than US $ 450 billion of financing per year and more than US $ 2 trillion in financing outstandings in the US.

The core concept of securitization pertains to the segregation of the assets to be securitized from the credit risk of entities involved in financing, except, in some instances, for FIs, which provide credit enhancement for the securitized assets. Assets to be securitized are transferred by the asset owner (the originator or transferor) to a special purpose vehicle (SPV) as the asset purchase. The SPV may be a corporation, trust or other independent legal entity. The SPV issues securities to public or private investors in the capital markets, which are backed (ie secured), by the cash payment streams generated by the assets securitised and by the assets themselves. The net proceeds received from the issuance of the securities are used to pay the transferor for the assets acquired by the SPV.

The principal advantage of securitization is the separation of the transferor’s credit risk from that of the SPV. By segregating its credit risk in securitisation, a transferor can access the capital market at a lower cost of financing because (a) significant differential exists between the stream of cash payments that can be generated by the assets segregated and the cost of securitization, and (b) the credit of securitization is based primarily on the credit of the source of the cash payment streams generated by the assets segregated and on credit enhancement, if any. In securitization, investor’s focus mainly on the credit and liquidity of the assets securitized and on the structure of the financing—not on the transferor’s credit risk.
Assets that have been securitized in structured financings in the US include, among others, mortgages, automobiles, aircraft, equipment and municipal leases, credit card receivables, hospital, retail and trade receivables, real estate, purchase contract for natural resource assets such as oil, gas and timber, student and home equity loans.

The principal disadvantage of securitization is its complexity. Securitisation, typically being transaction-specific, is more costly to structure and implement, than other more traditional forms of secured financing. Therefore, securitization is an appropriate alternative to traditional secured financings only if the securitization costs are lower than the cost of funds accessed in the public or private capital markets or if other material benefits are realized from the securitization deal.

Most securitization deals in India have been related to transport sector financing while there have been some towards housing receivables. In India, securitization dates back to 1991 when Citi bank securitized auto loans and placed a paper with GIC mutual fund. Since then, a variety of deals have been undertaken. According to some estimates, 35 percent of all securitization deals between 1992 and 1998 were related to hire purchase receivables of trucks and the rest towards other auto/transport segment receivables. These apart, SBI caps structured an innovative deal in 1994-95, where a pool of future cash flows of high value customers of Rajasthan state Industrial and Development Corporation was securitized. The recent securitization deal of Larsen and Toubro has opened a new vista for financing power projects. National Housing Bank (NHB) has also been making efforts to structure the pilot issue of mortgage backed securities (MBS) within the existing legal, fiscal and regulatory framework.

In October 1999, the parliament was presented with amendment to the securities contracts (Regulation) Act that seeks to redefine ‘securities’. The amended definition is broad and covers securitization instruments also. The results of the amendment, when finally adopted, is expected to bring securitization public offers under the regulation of the securities regulatory body.
In future, financial entities will be judged more by the informal strength and capital base rather than by the external support from the Central Bank or the Government. Market penetration of financial institutions in the area of loan origination in future will be determined more by the volume of loans originated during a period than by the amount of loans owned at a particular point of time. As the structure of the financial system evolves over time, it is expected that securitisation will play a much more important role in the future.

Group suggested the increased flow of information through credit bureaus, standardization of documents, improvement in the quality of assets, upgradation of computer skills and exploring the possibilities of securitizing NPAs. As a long term measure, the group underscored the need to develop insurance / guarantee institutions to give comfort to investors, especially in infrastructure/mortgage sectors. Adequate disclosure norms have also been suggested to facilitate informed decision-making by investors. The Report also suggested that the Government might consider bringing out an umbrella legislation covering all aspects of securitization. The Reserve Bank has set up an Implementation Committee for suggesting the framework for giving effort to the above recommendations.