Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002:
An Analysis

With the growing volume of Non Performing Assets (NPAs), Banks and Financial Institutions were experiencing considerable difficulties in recovering loans and enforcement of securities charged to them. A significant portion of the bank's funds were blocked in non-productive assets/litigation. Banks had to wait in long queues for their turn for hearing of their recovery suits by the courts like any other private money lenders. With advent of the Recovery of Debts Due To Banks and Financial Institutions Act, 1993 there was a great hope within the banking circle that most of the Non Performing Assets (NPA) shall be easy to recover. The banks, under the conventional system of recovery of loans, had a considerable amount of money blocked in form of unproductive assets. This Act intended to provide for expeditious adjudication and recovery of debts due to banks and financial institutions. But this effort of the government was not enough. To fight the menace of the NPAs the Indian banks required more teeth. With an object to give the banks more powers and skill the government decided to bring in the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (Popularly know as Securitization Act, 2002 Act) changed India's entire law on the recovery of non-performing loans by banks and financial institutions. The Act confers powers on secured creditors to take possession and sell assets kept as security if a default is committed by the borrower in repaying secured debt. The 2002 Act aims to regulate securitization, reconstruct financial assets and enforce security interests. Prior to 2002 there was no provision for facilitating securitization of financial assets and the power to take possession of securitized assets and selling them off. This act has come at a boon for the Indian banking industry and at a time when the industry was grappling with bad loans, which at that time accounted for 14% of their advances in gross terms and net NPAs at around 7%, which roughly amounted for upto Rs. 650 billion. Before,
discussing the important provisions of Securitization Act and implications, it is better to have a plain image of concept of securitization.

**Concept of Securitization**

Securitization is the buzzword in today's world of finance. It is neither a new subject to the developed economies nor a new concept for emerging markets like India. Securitization is 'structured project finance'. The popular use of the term structured finance in today's financial world is to refer to such financing instruments where the financier does not look at the entity as a risk; but tries to align the financing to the specific cash accruals of borrowers. Securitization is the process of pooling and re-packaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. In simple words-selling the cash flow generated from the assets (either existing or future) against the charge of the assets, by converting them into homogenous market negotiable instruments is known as securitization. The present day meaning of securitization is a blend of two forces that are critical in today’s world of finance: Structured Project Finance and Capital Markets. The process of securitization creates the strata of risk return and different maturity securities and is marketable into the capital markets as per the needs of investors. The following types of assets can be securitized:

1. **existing assets in form of long term receivables e.g. housing loans**
2. **existing assets in form of short term receivables e.g. credit cards etc.**
3. **existing physical assets in the nature of current assets e.g. stocks etc.**
4. **existing fixed assets in the nature of fixed assets e.g. air crafts lease rentals etc.**
5. **future receivables-infrastructure projects.**

**How to Securitize?**

Assets pools are to be created first. The criteria for doing so include demographics (what to sell), health statistics (performance history), and their literacy levels (cash flow signatures). Then, pool selection will be based on filters, optimistic criteria and certain empirical imperatives. Filtering does rating and ranking of the loans to exclude the unacceptable ones. Optimizing criteria includes regulatory considerations, risk management requirements, income augmenting motives etc. Empirical imperatives
concern about size of the pool for minimum scale economies and cost covering considerations. Then, problems arise for pooling from sheer geographic jurisdictions because it becomes difficult to assign credit ratings to these different jurisdictions assets. The reasons is that the different rating agencies set different performance criteria for different jurisdictions as each pool will be subject to different stress scenarios. Also, availability of third party services and above all efficient and detailed data systems constitute a pre-requisite for any decision as to what to securities. A typical securitization transaction consists of the following steps:

1. **Creation of a special purpose vehicle (SPV) to hold the financial assets underlying the securities**;
2. **Sale of the financial assets by the originator or holder of the assets to the special purpose vehicle, which will hold the assets and realize the assets**;
3. **Issuance of securities by the SPV, to investors, against the financial assets held by it**.

This process leads to the financial asset being take off the balance sheet of the originator, thereby relieving pressures of capital adequacy, and provides immediate liquidity to the originator.

**When Can Securitization Occur?**

When the originators expect to benefit by way of cost reduction or higher returns, by securitizing, they initiate the process. If the value of the new securities exceeds the value of the underlying assets, securitization would be beneficial.

**The Cost Factor**

The cost of carrying a bank loan in its balance in its balance sheet consists of four distinct components follows:

\[ r_1 = r_2 c + [(1-c)r_3/(1-k)] + a + n \]

- \( r_1 \) = Lending rate (PLR Plus)
- \( c \) = Equity ration on asset ratio
- \( r_2 \) = Required return on equity capital
- \( r_3 \) = interest rate paid on deposit including servicing cost and deposit insurance
- \( k \) = effective cash reserve ration (net of interest earned on eligible CRR balance)
- \( a \) = servicing cost of loan per rupee net of recoveries
- \( n \) = expected loan loss per rupee net of recoveries
Now define $s = (r_4 - r_3)$ as the spread. Suppose the cost of commercial paper borrowing can be split into:

$$CP = r_4 + CU$$

Where

- $CP =$ cost of commercial paper borrowing
- $r_4 =$ return to the investor in commercial paper
- $CU =$ underwriting cost of commercial paper

The borrower would prefer to use the commercial paper if $r_4 > CP$. But securitization can occur once $s > r_4 - r_3 + CU$. At the margin, $s = (r_4 - r_3) + CP$ and the borrower will be indifferent between a bank loan and commercial paper borrowing. This securitization becomes profitable so long as the lending rate exceed the rate on commercial paper plus cost of underwriting the commercial paper.

**Systematic Benefits of Securitization**

*Reduced Risk of Exposures and Augmented Fee Incomes:* The most obvious benefits of securitization is that the financial intermediacy shifts all or some of its credit risk to other market players. This reduction in credit risk also frees banks simultaneously and more or less fully from liquidity risk, interest rate risk and signature risk. Liquidity risk is reduced because there is not need to refinance the loan throughout its life. This will have a beneficial impact on the duration of the asset portfolio and hence on the interest rate risk. Signature risk is absent because the security issued against the debt sold carries an external guarantee against default. The other benefit is that part of net interest income from banks is replaced by fee income. This implies that banks will receive larger non-cyclical revenues which will stabilize bank revenues. This will help the banks become procyclical and as a result, their ability to ease their own credit constraints will be strengthened. In the end, this might help prevent the system from experiencing large business fluctuations.

*A New Deal for Risk Management:* the most obvious benefit of securitization as mentioned above on reduced risk exposure is, of course, credit risk reduction in the loan portfolios of banks. Now, there is a new deal that securitization provides when it is
combined with credit derivatives which themselves are meant for hedging credit risk. The first experiment has, already, been conducted successfully by the Citi Bank since June 1999 and it is called operation C*Star. The transaction used a credit default swap combined with a series of credit linked notes to transfer the bank’s credit risk underlying a portfolio of European corporate loans. The benefit is regulatory capital is freed upto the extent. This process is called synthetic securitisation where products take advantage of both the benefits of securitisation and credit derivatives. A Jersey-based SPV (Special Purpose Vehicle) issued credit-linked notes with German Government bonds. Citibank entered into a credit default swap with the SPV to lay off the bank credit’s risk. Banque Nationale DE Paris (BNP) followed the Citibank model and conducted a similar deal in July 1999. of course, the benefits of the deal will come down once the new Basel proposal are adopted as they involve internal credit risk rating compared to what the present standalone capital norms advocate. That is why BNP has kept the option to close the deal after two years.

A Better Way of Hedging Operational Risk: A New Basel proposals emphasize capital to be earmarked for hedging operational risk is akin to catastrophe risk, risk mitigation approaches cannot avoid it. No insurance will be able to cover operational risk because in case of a catastrophe which cannot save the institution, the insurer himself might default in paying out a large loss. Or even without default, payments might get delayed due to litigation and due to inadequacy of the existing insurance policies and their legal provisions. Capital prescription against operational risk is, perhaps the most expensive in an environment of severity-of-loss events being highly random. Only securitisation of operational risk using operational risk-linked risk bonds can see an institution safely through an operational risk catastrophe. The feasibility, the pricing and the robustness of these bonds can be easily worked out including the necessary legal provisions on the lines of the weather derivatives. From the investor’s point of view, these bonds offer better diversification opportunities when compared to the regular bonds. As these bonds exhibit zero correlations with market or credit events, the efficient investment frontier gets raised with no substantial increase in risk. A study of the “cat bonds” (catastrophe risk linked bonds) seemed to have revealed that a 5 percent additional of “cat bonds” to regular portfolio increased the average return five times more than the risk added to the portfolio.
Securitization for Insurance Risk Sharing: securitization can best serve as a viable risk sharing technique for insurable losses. It can effectively reduce the costs of financial distress to insurers. The insurers can pass off some of the systemic risk to the insured by offering “variable participation policies”. Of course, this depends on the reparability of the systematic and idiosyncratic risk components of insurable risks. For instance, the domestic property or causality insurance industry can dramatically reduce its potential losses from a catastrophe by issuing “cat bonds” with “cat puts” or even building a “forgiveness option” into contract. High potential losses due to earthquakes, hurricanes etc., can be minimized. All that is required is some simple changes in primary insurance contracts. After all securitization is considered a substitute for reinsurance because it allows insurers to transfer access risk.

Securitization Strengthen the Financial System: with reduced loan losses and the resultant need for making lower provisions, the bank revenue stability contributes to greater competition in the banking system. This is because, new market players can more easily compete as the advantages of economies of scale and the scope in traditional lending will largely be reduced with securitization spreading fast. This increased competition wills help borrowers with lower loan costs. Therefore, securitization is an important step forward for financial system. Looking beyond the financial system, securitization should help strengthen the foundation of the capital markets as the availability of new and more types of securities will be able to stimulate additional business. The advanced experience of the US, in this regard, richly confirms the above-mentioned conjecture. Furthermore, the broadening of the ranges of investment vehicles followed by a period of acclimatization could also open up a new channel for long term capital inflows in addition to short term portfolio funds. It depends on the monetary authority’s polices priorities and strategies.

Neutral Policy Stance: securitization of debt, practically medium-and long term debt, tends to consolidate savings while reducing transformation by the banking sector. If it proved capable of attracting new long term savings, the effect on monetary aggregates would be favorable and hence monetary policy friendly. Otherwise, securitization is neutral in its effects on monetary aggregates. Regardless, of whether the investors funds in securitization flow from a decline in bank deposits or a switch out of existing saving
instruments, the effect on total credit to the non financial sector will be neutral. But securitization would definitely broaden the base of operation of the central bank’s interest rate policy. Finally, securitization does not alter the balance between savings and investment in the economy. India has legal framework for securitization with the enactment of the “The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002” (The Act). Its purpose is to promote the setting up of asset reconstruction/securitisation companies to take over the Non Performing Assets (NPA) accumulated with the banks and public financial institutions. The Act provides special powers to lenders and securitization/ asset reconstruction companies, to enable them to take over of assets of borrowers without first resorting to courts.


The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (here-in-after referred to as The Securitization Act) has been enacted with an intention to strengthen the creditors rights through foreclosure and enforcement of securities by the banks and financial institutions (here-in-after FI) by conferring on the creditors the right to seize the secured asset and sell of the same in order to recover dues promptly bypassing the costly and very time consuming legal process through courts. The Securitization Act empowers the banks and FIs to move on its own against a borrower whose assets are secured, and who has made some kind of default in repayment of the same. The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law. Thus after complying with the statutory provisions in the said act the banks can: (1) Take possession of the secured assets of the borrower. This includes the right to transfer by way of lease, assignment or sale of the same for realization of the secured debt (2) Take over the management of the secured asset including the right to transfer by way of lease, assignment or sale of the same for realization of the secured debt and (3) Appoint any person to manage the secured asset.

With effect from 23rd April, 2003; ‘The Securitization Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions. 2003’ are operational in India. These guidelines and directions apply to securitization companies or reconstruction companies (SC/RC) registered with the Reserve Bank of India under section 3 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. The salient features of the Securitization Act are list below:

- Incorporation of special purpose vehicles namely securitization company and reconstruction company.
- Securitization of financial assets.
- Funding of securitization.
- Asset reconstruction.
- Enforcing security interest, i.e., taking over the assets given as security for the loan.
- Establishment of a central registry for regulating and registering securitization consortium/multiple transactions: One objective of the Securitization Act is to provide for the enforcement of security interest i.e., taking possession of the asset given as security for the loan. Section 13 of the Securitization Act contains elaborate provisions for a lender (referred to as ‘secured creditor’) to take possession of the security given by borrower.
- Offence and penalties.
- Boiler-plate provisions.
- Dilution of provision of SICA
- An NPA, including a non performing bond-debenture.
- A standard assets is assets when
  - The asset is under consortium/multiple banking arrangements.
  - At least 75% by value of the asset is classified as non-performing asset in the books of other banks/FIs; and
  - At least 75%(by value )of the banks/FIs who are under the consortium/multiple banking arrangements agree to the sale of the asset to SC/RC.
The securitization and Reconstruction of Financial assets and Enforcement of Security Interest Act, 2002 (SRFAESI Act) allows acquisition of financial assets by SC/RC\(^1\) from any bank/FI on mutually agreed terms and conditions. The salient features of the Act relevant to banks and those relating to securitization and reconstruction companies are summarized below:

- The sale of financial assets can be ‘without resource’, i.e., the entire credit risk associated with the financial assets to be transferred to SC/RC, or ‘with resource’, i.e., subject to unrealized part of the assets reverting to the seller bank/FI. However, the net effect of the sale of assets should be the removal of the assets from the bank’s books.

- Each bank will make its own assessment of the value offered by the SC/RC for the financial assets and decide whether to accept or reject the offer. In the case of consortium/multiple banking arrangements, if 75 per cent (by value) of the banks/FIs decide to accept the offer, the remaining banks/FIs will be obliged to accept the offer.

- Under no circumstances can a transfer to the SC/RC be made at a contingent price whereby in the event of shortfall in the realization by the SC/RC, the banks/FIs would have to bear a part of the shortfall.

- Banks/FIs may receive cash or bonds or debentures as sale consideration for the financial assets sold to SC/RC.

- Bonds/debentures received by banks/FIs as sale consideration towards sale of financial assets to SC/RC will be classified as investments in the books of banks/FIs. Banks may also invest in security receipts, pass-through certificates (PTC\(^2\)), or other bonds/debentures issue to SC/RC. These securities will also be classified as investments in the books of banks/FIs.

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\(^1\) Other banks/financial institutions/NBFCs can also buy loan assets from banks/FIs, as per the draft guidelines dated April 12, 2005, issued by the RBI titled ‘Draft Guidelines on Purchase/Sale of Non Performing Assets’. The conditions for such proposed sale are similar to those described for SC/RC.

\(^2\) PTC constitutes a pool of fixed income securities backed by a package of assets. A servicing intermediary collects the monthly payments from issuers and, after deducting a fee, remits or passes them through to the holders of the pass through certificates. Also known as ‘pass-through security’ or ‘pay through security’. The most common type of pass through is a mortgage backed certificates where homeowner’s payments pass from the original bank through a government agency or investment bank to investors.
• When banks/FIs sell its financial assets to SC/RC, the assets will be removed from its books. If the sale is at a price below the net book value, the short fall should be debited to the profit and loss account of that year. If the sale is for a value higher than the NBV (Net Bank Value), the excess provision will not be reversed but will be utilized to meet the shortfall/loss on account of sale of other financial assets.

• When banks/FIs invest in the security receipts/pass through certificates issued by SC/RC in respect of the financial assets sold by them to the SC/RC, the sale will be recognized in books of the banks/FIs at the lower of (a) the redemption value of the security receipts/pass-through certificates; or (b) the NBV of the financial assets. The investment should be carried in the books of the bank/FIs at the price as determined above until its sale or realization, and the loss or gain must be dealt with in the same manner. The securities offered by SC/RC should satisfy conditions such as (a) having a term of less than six years; (b) carrying an interest rate not lower than 1.5 per cent above the prevailing bank rate; (c) being secured by the charge on transferred assets; (d) providing for part/full prepayment of the SC/RC sells the underlying assets before the maturity date of the security; (e) unconditional redemption of securities by SC/RC without linking to asset realization.

• For the purpose of capital adequacy, banks/FIs should assign appropriate risk weights to the investments in debentures/bonds/security receipts/PTCs issued by SC/RC and held by banks/FIs as investment.

• Banks/FIs, which sell their financial assets to an SC/RC, shall be required to make the prescribed additional disclosures in the ‘Notes on Accounts’ in their balance sheets.

• Sometimes, when financial assets can not be revived, the SC/RC will act as an agent for recovery for which it will charge a fee. Such assets will not be removed from the books of the bank/FI but realization as and when received will be credited to the asset account. Provisioning for the asset will continue to be made by the bank/FI in the normal course.
Amendment to the Securitization Act

The Supreme Court, in its judgment in the matter of Mardia Chemicals Ltd. and Others Vs Union of India and others upheld the constitutional validity of the SARFAESI Act but struck down Sub-Section (2) of Section 17 which provides for a deposit of 75% of the claimed amount before the appeal is admitted by DRT (debt Recovery Tribunal). The Supreme Court also held that after the service notice, if the borrower raises any objection or places facts for consideration of the creditor, the same may be considered with due application of mind and the reasons for not accepting the objection must be communicated to the borrower. However, the borrower will be able to move the Secured Creditor has taken the DRT only after the possession of secured asset.

To bring the provisions of the Act in conformity with the Judgment of the Hon'ble Supreme Court Order, to dissuade the borrower from indulging in dilatory tactics with a view to postpone the repayment of dues and to enable secured creditors to make speedy recovery by enforcement of securities, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has been amended by promulgation of the Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Ordinance, 2004 (Ord. 5 of 2004) on 11.11.2004. The salient amendments are as under:-

(i) The Secured Creditor will be able to take possession of the secured assets only after reasons for not accepting the objections of the borrower have been communicated to him in writing. After possession of the secured asset has been taken, the borrower can file an application before the DRT without any deposit. If the DRT does not dispose off the petition within 4 months, the borrower or the Secured Creditor can move the Debt Recovery Appellate Tribunal (DRAT) for directing the DRT for expeditious disposal of the application. After the disposal of the case by the DRT the borrower, if aggrieved, can appeal to the DRAT with a deposit of 50% of the decreed amount or as determined by the DRT but not lower than 25%.

(ii) To confer power upon the Appellate Tribunal to transfer all pending applications before different DRTs to one DRT.

(iii) To empower RBI to call for periodic returns and information from Securitisation Companies and Asset Re-construction Companies.
(iv) To provide for taking over of management of the business of the borrower under Section 13(4). This was omitted in the original Act. Though Section 15 provides for the manner and effect of take over of management of business, Section 13(4) did not provide for taking over the borrower's business by the Secured Creditor. Other amendments are of clarificatory and consequential nature.

**Exception to the Securitization Act**

But the application of this act is not absolute. It does not absolutely apply over all kinds of mortgage transactions. This Act will not apply in some of the following cases:

(i) A lien on any goods, money or security given by or under the Indian Contract Act or the Sale of Goods Act or any other Law for the time being in force;

(ii) A pledge of movables;

(iii) Creation of any security in any aircraft and any vessel;

(iv) Any conditional sale, hire purchase or lease or any other contract in which no security interest has been created;

(v) Any security interest for securing repayment of any financial asset, not exceeding Rs. 1,00,000/- (Rupees One lakh);

(vi) Any security interest created in agricultural land;

(vii) Any case in which the amount due is less than 20% of the principal amount and

(viii) Any rights of an un-paid seller and any property not liable to attachment or sale as per the Civil Procedure Code.

Other than freeing up the blocked assets of banks, securitization can transform banking in other ways as well. The growth in credit off take of banks has been the highest in the last 55 years. But at the same time the incremental credit deposit ratio for the past one-year has been greater than one. What this means in simple terms is that for every Rs 100 worth of deposit coming into the system more than Rs 100 is being disbursed as credit. The growth of credit off take though has not been matched with a growth in deposits. Banks essentially have been selling their investments in government securities. By selling their investments and giving out that money as loans, the banks have been able to cater to the credit boom. This form of funding credit growth cannot continue forever, primarily because banks have to maintain an investment to the tune of 25 per cent of the
net bank deposits in Statutory Liquidity Ratio (SLR) Instruments (government and semi
government securities). The fact that they have been selling government paper to fund
credit off take means that their investment in government paper has been declining. Once
the banks reach this level of 25 per cent, they cannot sell any more government securities
to generate liquidity. And given the pace of credit off take, some banks could reach this
level very fast. So banks, in order to keep giving credit, need to ensure that more deposits
keep coming in. One way is obviously to increase interest rates. Another way is
Securitisation. Banks can securitize the loans they have given out and use the money
brought in by this to give out more credit. A.K. Purwar, in a recent interview to a
business daily remarked that bank might securitize some of its loans to generate funds to
keep supporting the high credit off take instead of raising interest rates. Not only this,
securitization also helps banks to sell off their bad loans to asset reconstruction
companies (ARCs). ARCs, which are typically publicly/government owned, act as debt
aggregators and are engaged in acquiring bad loans from the banks at a discounted price,
thereby helping banks to focus on core activities. On acquiring bad loans ARCs
restructure them and sell them to other investors as PTCs, thereby freeing the banking
system to focus on normal banking activities. A recent survey by the Economist
magazine on International Banking, says that securitization is the way to go for Indian
banking. As per the survey, "What may be more important for the economy is to provide
access for the 92% of Indian businesses that do not use bank finance. That represents an
enormous potential market for both local and foreign banks, but the present structure of
the banking system is not suitable for reaching these businesses.

Debt Recovery Dilemma: RDDB&FI V/s SARFAESI
Money maketh the world go round, and now it is making the legal fraternity ponder, too.
Many a times, the interpretation of statutes becomes a tedious job, mostly due to the clash
of legislations- their ambit and scope. On the surface what may seem as supplementary
legislations, may in reality be two diverse tools of laws addressing different issues
altogether. There are many situations, which neither the courts nor the legislators
imagined would crop up. One of such issue is the conflict created by defaulters. And the
statutes in question are the Recovery of Debts Due to Banks and Financial Institution
RDDB&FI Act, 1993 and the Securitisation and Reconstruction of Finance Assets and Enforcement of Securities Interest (SARFAESI) Act, 2002. The choice of remedy which one creditor has against the debtor creates a problem of choice for the creditors. Is there actually a choice for the creditor? Choice of remedy is governed by the theory of election of remedies, which gives the creditor the liberty of choosing one out of several means afforded by law for the redressal of an injury, or one out of several available forms of action. An "election of remedies" arises when one having two co-existent but inconsistent remedies chooses to exercise one, in which event he loses the right to thereafter exercise the other.

The Supreme Court dealt with this issue in Andhra Pradesh State Financial Corporation v M/s GAR Re-Rolling Mills wherein the Court held that "the doctrine of election clearly suggests that when two remedies are available for the same relief, the party to whom the said remedies are available has the option to elect either of them but that doctrine would not apply where the ambit and scope of the two remedies are essentially different. To hold otherwise may lead to injustice and inconsistent results. Since the corporation must be held entitled and given full protection by the court to recover its dues it cannot be bound down to adopt only one of the two remedies provided under the Act".

There is, however a considerable difference in the scope and legislative utility between RDDB&FI and SARFAESI. A thorough understanding of SARFAESI shows that it is an act to regulate securitization and reconstruction of financial assets and enforcement of security interest; whereas RDDB&FI is there to establish Tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions. Moreover, only secured creditors can refer to SARFAESI, whereas RDDB&FI is for all types of creditors whether or not they are secured or unsecured. Both these statutes throw an insight on the recovery of money due from defaulters to the banks and financial institutions.

The Debt Recovery Tribunal, Ranchi dealt with this issue in Sushil Kumar Agarwal v Allahabad Bank wherein it held that "the question that arises is whether during pendency of the suit, the defendant Bank can resort to Section 13(4) of the SARFAESI Act, 2002. So when alternative method has been prescribed to recover the amount, which the petitioner is liable to pay, and the bank in order to enforce payment has taken recourse to
the Act, which has the overriding effect over other laws, no fault can be found with defendant bank in proceeding under the Act”.

The same issue came to light yet again, before the Debt Recovery Appellate Tribunal, Chennai in ARCIL v Kumar Metallurgical Corporation Limited wherein the Appellate Tribunal held that there is no question of applicability of doctrine of election as the RDDB&FI Act covers secured as well as unsecured dues, while the SARFAESI Act takes into account only secured assets and secures interest of secured creditors only.

It is not doubtful that the intention behind enacting both the Acts is complimentary to each other, but they operate in different spheres. The RDDB&FI Act is for expeditious adjudication at the hands of Tribunals, while the SARFAESI Act bypasses intervention of the courts for expeditious recovery of dues of banks and financial institutions, which is public money of which they are custodian. The Appellate Tribunal further held that Section 37 (application of other laws not barred) makes it clear that the provisions of the SARFAESI Act are in addition to the provisions of the RDDB&FI Act, 1993.

To conclude, thus, the ambit and scope of the two remedies provided by the RDDB&FI Act and SARFAESI Act, is distinct, and has different shades. RDDB&FI Act is an adjudicating act and SARFAESI Act is executory in nature. There is no adjudication process at least, till action under Section 13(4) is taken. It is another thing that, thereafter, the legality of the action taken by secured creditor under Section 13(4) can be challenged by filing appeal under Section 17 of the Act.

Implications of Securitization Act

It is well accepted fact that the present legal framework in India is to some extent debtor friendly. Many defaulting borrowers know that banks can not force them to repay quickly and even if banks have the collateral, due to long time taken in the judicial processes, it is practically impossible to take over the security. Debt Recovery Tribunals, set up for speedy enforcement of law against defaulting borrowers, have not so far made much of a dent in the NPA position of banks. The present bankruptcy and liquidation processes are fraught with the loopholes which defaulters make use of stalling the loan recovery process. The Securitisaiton Act, promulgated by President of India in June 2002 is an important initiative to recover NPAs. The Act empowers the creditors and provides a
legal framework for the securitization of assets and assets reconstruction through
dedicated asset reconstruction companies. The act has number of remarkable provisions
and their implication is given as under:
The Guidelines seem to have made a significant departure from the definition of the NPA
under the existing Reserve Bank of India ("RBI") guidelines. Receivables are to be
treated as NPAs if the same remain overdue for a period of 180 days or more. While this
is in accordance with existing RBI norms for classification of debts as NPAs, section
3(vi) of the Guidelines also states that the board of directors of a Securitization (or
Reconstruction) Company may, on default by the borrower, classify an asset as a non-
performing asset even earlier that the said 180 days for the purposes of facilitating
enforcement as provided for in section 13 of the Act. As per section 13, where any
borrower makes a default in repayment of a secured debt and his account is classified as
an NPA, the secured creditor (or as the case may be the Securitization Company)
becomes entitled to exercise the recovery rights under the Act, after providing for a 60
day notice to the borrower. The Guidelines therefore permit a Securitization (or
Reconstruction) Company to classify a debt as an NPA and proceed to give the aforesaid
60 day notice under the Act immediately upon default by the borrower, without having to
wait for the aforesaid 180 day period.
The sale of financial assets from a bank/FI may be on a "without recourse" basis, i.e.,
with the entire credit risk associated with the financial asset being transferred to the
Securitization (or Reconstruction) Company, as well as on a "with recourse" basis, i.e.,
subject to the unrealized part of the asset reverting to the seller bank/FI. Banks/FIs are
however, required to ensure that the effect of the sale of the financial assets should be
such that the asset is taken off the books of the bank/FI and after the sale there should not
be any known liability devolving on the bank/FI. It has also been clarified that under no
circumstances can a transfer to the Securitization (or Reconstruction) Company be made
at a contingent price whereby in the event of shortfall in the realization by the
Securitization (or Reconstruction) Company, the banks/FIs would have to bear a part of
the shortfall. Further, in the case of specific financial assets, where it is considered
necessary, banks/FIs may enter into agreements with the Securitization (or
Reconstruction) Company to share, in agreed proportion, any surplus realised by the
Securitization (or Reconstruction) Company on the eventual realization of the concerned asset.

The Guidelines clarify that a Securitization (or Reconstruction) Company that has obtained a certificate of registration issued by the RBI under the Act can undertake both Securitization and Reconstruction activities. The Guidelines also clarify that an entity that is not registered with the RBI may conduct the business of Securitization or Asset Reconstruction outside the purview of the Act. This is a significant clarification as the Act is silent in this regard. In view of this clarification, banks and financial institutions that were engaged in securitisation activities prior to the Act can continue the same without having to obtain a certificate of registration under the Act. The benefits of the enhanced enforcement rights under the Act however, will not be available to them.

This Act lays the emphasis on recovery of the money, even without the intervention of Court. The Banks were empowered under Section 13(4) of Securitization Act to take possession of Secured Assets of the Borrower including the right to transfer by way of lease, assignment or sale for realizing the Secured Asset. The role of the Court was limited to challenge the measures under Section 13(4), by way of Appeal, that too on deposit of 75% of amount claimed on the notice under Section 13(2) of Securitization Act. In effect the Securitization Act, 2002 did away with the first aspect of recovery of dues i.e. ascertainment of dues but concentrated only on the second aspect i.e. executing the decrees. The first aspect was put to impossible conditions for challenge like pre-deposit of 75% of amount ascertained by the Banks & not Courts of law. The result of which is Hon'ble Supreme Court in Mardia Chemicals Vs. The Union of India strikes down the condition for deposit as ultra virus of the Constitution, which makes the Securitization Act, 2002 almost redundant for recovery of dues.

The Securitization Act provides that borrowers aggrieved by the lenders' action under the Act can approach the DRTs for relief. Lenders had earlier pointed out to the Ministry that the legal requirement of withdrawing DRT cases before initiating action against a borrower under the Securitization Act threatens a large number of recovery cases that may get time-barred for any further action before the Tribunals. They had argued that there was a danger that once the cases are withdrawn from the DRTs, the lenders may not be able to approach the same forum for recovery of balance dues since the loan document
might get time-barred by the time action under the Securitization Act is completed. Under the present laws, a case before the DRT gets time-barred three years from the date the loan becomes sub-standard. This, in effect, means that the case has to be initiated before the expiry of the period. The Securitization Act permits secured creditors to take possession of assets or even take over the management of companies of defaulters after providing the borrower the requisite time to settle his dues. However, the DRTs are tribunals that the lenders can also approach for recovery of bad debts of all kinds. "There are conflicting opinions even from the DRTs on the matter. We wanted some clarity but, as it appears, the Government is not inclined to allow this," a top banker said. The Finance Ministry feels cases getting time-barred before the DRTs are a "transitory problem" which would be sorted out once the banks get used to sequencing the processes. Stating that three years "is too long a period" for banks to complete proceedings under the Securitization Act, the Ministry has said that there should be enough time to approach the DRTs to recover other dues.

The housing loan turf has turned uneven with the Securitization Act providing protection for banks vis-a-vis the right to enforce a mortgage and seize property in case a client has defaulted in payment. Why should one set of home loan providers be given protection while another goes without it? Viewed in this angle, the move to extend the ambit of the Securitization Act to cover housing finance firms is welcome. It is, however, a different matter that asset selling under the Act has become the subject matter of a legal dispute with the Supreme Court granting a stay in the Mardia Chemicals' case. The legal tangle relating to asset selling notwithstanding, the current proposal, should go a long way in quickening the tempo of the home loan market.

The act passed in 2002 was pretty strict as such on the borrower. It took away all the rights of the borrower to be heard. He could not approach the Civil Court nor did the DRT come to his rescue till his property had been attached and sold off. All this has been changed substantially after the land mark judgment of the Hon’ble Supreme Court in the case of Mardia Chemicals limited and Ors Vs. Union of India which inserted Section 3-A which says that if on receiving the notice under Section 13(2) the borrower makes in any representations or raises any objections, the secured creditor shall be compelled to consider such representations and if he comes to the conclusion that the objection is not
tenable, he shall communicate within 1 week the reasons in writing for the non acceptance. The Supreme Court held in that very case that, not to give any hearing to the borrower is not in conformity to the laws of a democratic state, being against principles of natural justice. Thus the act now provides the borrower the right to be heard but this being, not appealable, may seem to be not enough, but the Act does not take away from the borrower the right to move High Court under Art 226 & 227 (as writ petition) and the high courts can and have taken very serious views of banks not acting Bonafide and of the reasons communicated not being reasonable and have actually struck down the move of banks to attach and sell assets of the alleged defaulters.

The Act allows lenders and securitization companies to change or take over the management of the borrower and sell or lease the business of the borrower for the purpose of recovery of loans. However, the Guidelines state that no Securitization (or Reconstruction) Company shall take any measures for change or take over of management/sale or lease of the business of the borrower until the RBI issues necessary guidelines in this behalf. The guidelines prohibit a Securitization (or Reconstruction) Company from raising monies by way of deposit. A Securitization Company is permitted to raise funds from qualified institutional buyers (as defined in the Act) by issuing security receipts to them. It has been clarified that the security receipts would be transferable/assignable only in favour of other qualified institutional buyers.

The Guidelines impose restrictions upon the permissible modes of deployment of funds by Securitization (or Reconstruction) Companies. A Securitization (or Reconstruction) Company is permitted to invest in the equity share capital of another Securitisation (or Reconstruction) Company, as a sponsor and for the purpose of establishing a joint venture.

Apart from other measures regarding procedure and other methods for enforcement of security, one of the clauses which was relatively harsh on the borrower was, that, if any person including the borrower is aggrieved by any of the measures taken by the secured creditor, he may prefer an appeal to the Debt Recovery Tribunal within 45 days, only on depositing 75% of the amount claimed in the notice referred to hereinabove. Although the Debt Recovery Tribunal (DRT) has been empowered to waive or reduce the amount to be deposited for reasons to be recorded in writing, practically it was realised that it will be
difficult for any DRT to reduce the amount at that stage without going into all the relevant facts and circumstances of the case of the representation/objections raised by the borrower. The Hon'ble Supreme Court in the case of Mardia Chemicals limited and Ors vs. Union of India struck down the provision under Section 17(2) as being unconstitutional as it was unreasonable and unnecessary. Thus although it may seem that the act is thoroughly in favour of the Creditor (which it practically is) its not actually against the Indian legal framework and has a lot of credibility.

Hidden Truth

In some States such as Maharashtra, Gujarat, Rajasthan and Madhya Pradesh borrowers took advantage of certain state legislations which prevented banks from enforcing the act. In some cases, the DRT itself is said to be standing in the way of SARFAESI, being reluctant to let go of the cases. Moreover, the Act itself is inherently limited in its reach. According to a Crisil study, about 36 per cent of the outstanding NPAs are outside the jurisdiction of the Act on account of the exemptions provided by it. Agricultural loans and loans below Rs 1 lakh are outside its purview. Specifically, the Crisil study says, banks can apply the Act only to one-third of the gross outstanding NPAs. Despite these hurdles, apart from the Rs 450 crore recovered so far, action has been initiated under SARFAESI in another 1547 accounts involving Rs 476 crore. Public sector banks have sent notices to 28,866 entities for recovering Rs 10,171 crore under the Act. While these recoveries may seem insignificant in comparison to the overall level of NPAs in the banking system, the substantial amounts recovered in such a short time from long pending sticky loans is indeed commendable. Besides, the credit for the increasing response to OTS settlements mainly goes to the fear instilled in the hearts of the defaulters by the SARFAESI Act. However, the true success of these recovery measures, particularly the SARFAESI Act, is best gauged by the marked change they have brought about in the repayment/recovery culture in the banks. Even the most intractable of defaulters have come to realize that banks mean business at last in demanding their money back. Defaulters who lost touch with the banks for several years are rushing back anxious for a compromise settlement. Long pending and complicated cases, which may take years if taken to court, are resolved amicably at the OTS meeting. One major factor
slowing down compromise settlements is the subdued property prices. Most defaulters understandably want to settle the accounts by disposing of some property or the other. But they prefer to wait a while in the hope that property prices would look up. There is no disputing the fact that various debt recovery measures including the SARFAESI Act have had a salutary effect on the huge NPA burden of the banks. A recent study shows aggregate accretion of NPA in top public and private sector banks has declined for the first time in 2002-03. This means the NPA level has probably peaked for these banks and is likely to come down gradually. Recoveries are likely to surge once the SARFAESI Act is cleared in the Supreme Court. There is now a growing consensus among the bankers and borrowers alike that more stringent debt recovery measures will follow in the future. This augurs well for the backlog of NPAs with the banks; more importantly, it will have a healthy deterrent action on fresh slippage also.

Concluding Remarks
The SARFAESI Act, dramatically brought into force in mid-2002, added an element of non-conventional warfare to the battle against NPA, thereby impressing on both the bankers and the defaulters the urgency involved in the matter. The Act empowered the banks to sidestep the courts and dispose of the defaulters' properties given as securities to recover the dues after giving due notice. Though the Act sent the defaulters scurrying in panic, its progress has been plagued by one hurdle or the other. Expectedly, in the initial stages there was a lot of confusion over who were, by definition, defaulters under the Act, the modus operandi of issuing notice, taking possession and disposing of such securities, and so on. Subsequently, sale of security under the SARFAESI Act was stayed by the Supreme Court in the case of Mardia Chemicals, following which scores of big and small defaulters obtained similar stays in various courts. Further, Securitization is expected to become more popular in the near future in the banking sector. Banks are expected to sell off a greater amount of NPAs by 2007, when they have to shift to Basel-II norms. Blocking too much capital in NPAs can reduce the capital adequacy of banks and can be a hindrance for banks to meet the Basel-II norms. Moreover, even if the Securitization Act does not substantially reduce the amount of NPAs recovered in the near future, it will
serve the objective by showing borrowers that lenders have teeth and if necessary will not hesitate to use them, thereby limiting the build-up of future.

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