

# Sarfaesi Act: Easing Bad Debts of Banks In Banking System?

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## **Abstract**

*The functions of commercial banks have expanded tremendously with the advent of technology. Apart from the primary functions of receiving of money on deposits for lending of funds, investment of funds on securities, modern banks perform miscellaneous, subsidiary, special and para-banking services in addition to its main functions. Lending of funds constitute the main business of commercial banks and they lend funds to the public by way of (i) loans (ii) overdraft (iii) cash credits (iv) discounting of bills etc., While receiving deposits involves no risk, on the other hand, lending always involves much risk as there is no certainty of repayment. With the increasing Non Performing Assets (NPAs) or bad debts, The Recovery of Debts Due to Banks and Financial Institutions Act (RDDBFI Act) was enacted in 1993 for the expeditious adjudication and regulation of debts due to banks and financial institutions. However, after the enactment of RDDBFI Act, it was realised that for the recovery of loans and reducing the level of NPAs, additional measures were required to be introduced and it was this purpose, with a view to speed up the recoveries of the Banks and Financial Institutions (FIs) outstanding by realisation of security interest without the intervention of the court and in order to provide legal framework for securitisation of the assets, Securitisation Act was enacted by the Parliament. However, the Act itself was subject to number of amendments including the latest Amendment Bill of 2016. Still the question remains unanswered whether the banks can recover their bad debts at an easy pace?*

**Keywords:** NPAs, RDDBFI Act, SARFAESI Act, Bad Debt, Financial Institutions (FIs)

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## **Introduction**

The institution of banking in India in its present form has developed over a long period of time and its development can be traced back to the Vedic period between 2000 and 1400 B.C. There is difference of opinion as to the origin of the word 'Bank' itself. Some historians are of the view that the word 'bank' originated from the French word "bancus" or 'banque' and the Italian word 'banco' both meaning 'bench'. There is another view that it owes its origin from the German word 'back' which means a 'joint stock fund' which was latter on converted by Italians into 'banco' (Tannan 2015). Whatever difference of opinion may be there, it would trace the history of banking in Europe from the middle ages. Banking in ancient India simply meant 'money-lending' that was undertaken by the Vaisya community who carried out the business of banking by accepting deposits and giving credit. The study of evolution can be analysed under different periods i.e., the Buddhist period , Muslim period , Mughal and the coming of East Indian Company. Later there was rise of joint stock banks in India. Presidency banks were established and the three Presidency banks were functioning like central banks discharging central banking functions. The year 1865 witnessed the rise of banks set up under European management. First

purely Indian management joint bank, Oudh Commercial bank was established in 1889 followed by Punjab National Bank and Peoples Bank of India. With Swadeshi movement in 1905, many banks were started by Indians and there was boom in Indian banking from the period 1906-1913. However, this development in banking sector did not last long as there was a set back during 1913-17, 1922-36 and from 1937-48. However, the establishment of Reserve Bank of India marked the beginning of a new era in the history of Indian banking.

### **Primary Functions of Bank**

With the liberalisation policy, RBI decided to allow banks in private sectors and in 1993 RBI issued guidelines for setting up of private sector banks in India (RBI 1993: 2011). Narasimham Committee recommended that new banks in private sector should be allowed and they should perform the minimum capital, other requirements and prudential norms. Committee also suggested that there should not be difference in treatment between public sector and private sector banks. Thus the banking sector has undergone a phase of metamorphosis and the functions of commercial banks expanded tremendously. The advent of technology gave a new impetus to the commercial banks. Apart from the primary functions of receiving of money on deposits for lending of funds, investment of funds on securities, modern banks perform miscellaneous, subsidiary, special and para-banking services in addition to its main functions. Lending of funds constitute the main business of commercial banks and they lend funds to the public by way of

- **Loans**

A loan is a financial arrangement under which an advance is granted by a bank to a borrower on a separate account called loan account. A loan is generally granted for a short period of one year or less, such loan is called a term loan. If the loan is given for a period ranging from more than one year to five or seven years it is called a medium-term loan and if it is given for still longer period it is long-term loan (Raman 2010: 28).

- **Overdraft**

An overdraft is a financial arrangement under which a current account holder is permitted by the bank to overdraw his account. That is, to draw more than the amount standing to his credit, upon an agreed limit. Overdraft may be a clean overdraft and secured over draft.

- **Cash credits**

Cash credit arrangement is the most popular method of borrowing for borrowers in many countries. It is a financial arrangement under which a borrower is allowed an advance under a separate account called cash credit account upon a specified limit called the cash credit limit.

- **Discounting of Bills of Exchange**

When a bank gives funds in exchange for a promissory note or a bill of exchange, the transaction is known either as a discount or a loan. It is an arrangement under which a bank takes a bill of exchange maturing within a short period of 60 days or 90 days from an approved customer and pays him or credits his current account immediately on the present value of the bill. On the due date of the bill, the bank receives the face value of the bill from the acceptor of the bill.

While receiving deposits involves no risk, on the other hand, lending always involves much risk as there is no certainty of repayment. Although the banks follow the principles of safety,

liquidity and look into the purpose for which loan is required and security offered in granting loans and advances to the customers, the increasing Nonperforming assets (NPAs) were always a matter of concern to the banks (Gupta 2012). With the increasing NPAs, The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI Act) was enacted in 1993 for the expeditious adjudication and regulation of debts due to banks and financial institutions.

### **Legal Framework for Recovery of Bad Debts In India**

The NPAs growth has a direct impact on profitability of banks. Although on the recommendations of Narasimham committee and Verma committee, some steps have been taken to solve the problem of old NPAs, there seems to be no unanimity in the proper policies to be followed in resolving this problem. NPAs reflect the performance of banks. The steps taken by the government to tackle the growing NPAs can be analysed in the light of two legislations:

- I. The Recovery of Debts due to Banks and Financial Institutions Act, 1993

The existing procedure for recovery of debts due to the banks and financial institutions had blocked a significant portion of their funds in unproductive assets. The Committee on the Financial System headed by Shri M. Narasimham considered the setting up of the Special Tribunals with special powers for adjudication of such matters and speedy recovery as critical to the successful implementation of the financial sector reforms. An urgent need was, therefore, felt to work out a suitable mechanism through which the dues to the banks and financial institutions could be realized without delay. In 1981, The Tiwari Committee also suggested setting up of Special Tribunals for recovery of dues of the banks and financial institutions by following a summary procedure. Thus RDDBFI Act was enacted in the year 1993 to provide for the establishment of Tribunal and Appellate Tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions. Prior to the enactment of RDDBFI Act, if the banks and financial institutions had to recover the money from its borrowers, it had to resort to the proceedings of civil suits in the appropriate civil courts. However, with the advent of time the existing lacunae in the enactment was severely misutilised by lawyers and borrowers, which consequently led to the dues being blocked in the web created by them. Thus, in view of the alarming increase in the dues of banks and financial institutions to the tune of Rs 12,000 crores, the Central Government was forced to introspect the existing provisions of the legislation. This situation led the government to appoint another committee under the chairmanship of Mr. Andhyarujina to examine banking sector reforms and to consider the changes in the legal system. The Narasimham committee as well as the Andhyarujina committee suggested the enactment of a new legislation for the establishment of securitisation and reconstruction companies and to empower the banks and financial institutions to take possession of the non-performing assets. These powers were sought to be granted through the enactment of The Securitization and Reconstruction of Financial assets and Enforcement of Security Interest Act, 2002.

- II. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

The new legislation aimed at:

- (i) Facilitating Securitization of financial assets of banks and financial institutions with or without the benefit of underlying securities.
- (ii) Facilitating easy transferability of financial assets by the Securitization Company or

Reconstruction Company to acquire financial assets of banks and financial institutions by issue of debentures or bonds or any other security in the nature of a debenture.

- (iii) Empowering Securitization companies or reconstruction companies to raise funds by issue of security receipts to qualified institutional buyers.
- (iv) Facilitating reconstruction of financial assets acquired by exercising powers of enforcement of securities or change of management or other powers which are proposed to be conferred on the banks and financial institutions.

The constitutional validity of the Securitisation Act as a whole was challenged before the Apex Court by substantive petition and there were also other petitions preferred before the High Court which were substantially transferred to the Apex Court. The Apex court in its decision *Mardia Chemicals Ltd & Ors. v. Union of India and Ors.*, after considering various provisions of the Act upheld its validity. In *M/s Travancore v. Union of India & Indian Overseas Bank* Supreme Court analysed whether banks and financial institutions having elected to seek their remedy in terms of RDDBFI Act can still invoke SARFAESI Act for realising the secured asset without withdrawing or abandoning the Original Application (OA) filed before DRT and held that the withdrawal of OA pending before DRT is not a pre-condition for taking recourse to the SARFAESI Act. The discretion is vested with the banks/financial institutions to apply for leave of DRT for withdrawal depending upon the circumstance of each case. However, the court did not spell out those circumstances.

- The Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2011  
The Act was recently amended in January 2013 by The Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2011 and the following major changes were brought about in the SARFAESI Act:
  - (i) The lenders were allowed to convert any part of the debt of the defaulting company into equity. Such a conversion would imply that lenders would tend to become an equity holder rather than a creditor of the company.
  - (ii) It allowed banks to bid for any immovable property they have put out for auction themselves, if they do not receive any bids during the main auction. In such a scenario, banks were able to adjust the debt with the amount paid for the property.
  - (iii) A securitisation or reconstruction company could substitute its name in place of the name of the original lender in any pending suit in the D.R.T. or D.R.A.T.
  - (iv) The amended Act allowed a secured creditor to file a Caveat in the D.R.T. if an appeal is expected to be preferred against it based on the proceedings of the lender under the Act. Once such caveat has been filed, the borrower as to inform the creditor details about the appeal that he will be filing or already filed.
  - (v) The Act provided the secured creditor to seek the assistance of the District Magistrate to take possession of a secured asset. The amendment laid down certain guidelines as to when such assistance can be asked for.
  - (vi) If the lender fails to inform the Central Registry/Central Government about the securitisation of an asset as laid down in Sections 23, 24, 25 of the Act, the court can take cognizance of such an offence only with the approval of the Reserve Bank of India or the Central Registry.

The Act has been criticized till date because it does not take into account the interest of the borrower's, on account of it being arbitrary and biased towards lenders. Borrowers are however, allowed to appeal against the action taken by the lenders by virtue of Section 17 of the Act, which lays down circumstances in which such an appeal, can be preferred. The Courts through various judgments have interpreted the Section 17 of the Act in a liberal way so as to give relief to borrowers in many circumstances. In spite of that, appeals rarely get accepted and in certain circumstances banks even get the opportunity to rectify the matter against which the appeal has been preferred.

More recently, steps are being initiated to make changes in the Securitisation act again and the new amendment bill was introduced in the Lok Sabha on May 11, 2016. It seeks to amend four laws (i) SARFAESI Act, 2002 (ii) RDDBFI Act, 1993 (iii) Indian Stamp Act, 1899 and (iv) Depositories Act, 1996. This provides for expeditious recovery of bad loans by banks which have to contend with nonperforming assets of Rs. 4 lakh crore and stressed assets amounting to Rs 8 lakh crore.

- The Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Bill, 2016

The bill has suggested amendments to SARFAESI Act and RDDBFI Act in the following lines:

Amendments to SARFAESI Act:

- (i) The SARFAESI Act allows secured creditors to take possession over collateral, against which a loan has been provided, upon default in repayment. This process is undertaken with the assistance of the District Magistrate and does not require the intervention of courts or tribunals. The bill provides that this process will have to be completed within 30 days by the District Magistrate.
- (ii) In addition, the Bill empowers the District Magistrate to assist banks in taking over the management of a company, in case the company is unable to repay loans. This will be done in case the banks convert their outstanding debt into equity shares, and consequently hold a stake of 51% or more in the company.
- (iii) The Act creates a central registry to maintain records of transactions related to secured assets. The Bill creates a central database to integrate records of property registered under various registration systems with this central registry. This includes integration of registrations made under Companies Act, 2013, Registration Act, 1908 and Motor Vehicles Act, 1988.
- (iv) The Bill provides that secured creditors will not be able to take possession over the collateral unless it is registered with the central registry. Further, these creditors, after registration of security interest, will have priority over others in repayment of dues.
- (v) The Act empowered the Reserve Bank of India (RBI) to examine the statements and any information of Asset Reconstruction Companies related to their business. The Bill further empowers the RBI to carry out audit and inspection of these companies. The RBI may penalise a company if the company fails to comply with any directions issued by it.
- (vi) The Bill provides that stamp duty will not be charged on transactions undertaken for transfer of financial assets in favour of asset reconstruction companies. Financial assets include loans and collaterals .

## Conclusion

The NPAs have always created big problem for the banks. As it is not at all possible to have zero NPAs, it is also to be understood that NPAs are inevitable in banking industry. But their magnitude should not be high. They should be kept within the tolerance limits. Although various steps have been taken by government to reduce the NPAs, still a lot needs to be done to curb the existing problems. The existing laws such as SARFAESI, 2002 and the RDDBFI, 1993 Acts are designed to exclusively benefit secured creditors such as banks and financial institutions while limited legal recourse is available to other unsecured creditors and operational creditors in the event of insolvency of the debtor firm. The Parliament has recently passed the Insolvency and Bankruptcy Code (IBC, 2016) which is a significant step towards improving the bankruptcy resolution framework in India. The IBC seeks to resolve this issue by according rights to all types of creditors, and not just secured financial creditors, to trigger insolvency proceedings against the debtor firm. However, IBC on its own cannot achieve better bankruptcy resolutions without the harmony of existing laws. Presently, there is inherent tension between laws for security enforcement, those for insolvency and bankruptcy resolutions. Therefore, what is required is that the proposed amendments to SARFEASI Act need to be modified in order to be consistent with the IBC. The question that still remains un-answered is whether the banks can recover their bad debts at an easy pace with the proposed recent amendments to the SARFEASI Act?

## End Notes

1. During Buddhist period, bill of exchange came into use and banking business extended to Brahmanas and Kshatrias. Business of banking developed during this period.
2. Metallic money was used for money transaction during Muslim period. This period also showed development of banking business.
3. Transfer of funds from one place to another at a fair distance took place with the help of 'hundis' during this period. The word 'hundi' is derived from the Sanskrit term 'hund' meaning to collect.
4. Mughal Emperors were providing assistance to British. Due to lack of facility for financing of foreign trade, Britishers were experiencing difficulty in Murshidabad and they shifted to Calcutta and established Bank of Hindustan, which later went into liquidation.
5. In 1806, Bank of Calcutta was established and was re-designed as Bank of Bengal in 1809. Bank of Bombay was established in 1840 and Bank of Madras was established in 1843.
6. Allahabad Banks was set up under the European management.
7. Punjab National Bank was set up in 1894 and Peoples Bank of India in 1901.
8. Many banks like Bank of India (1906) Central Bank of India (1911) Bank of Baroda (1908) were established.
9. Around 108 banks failed during 1913-17, 373 banks failed in 1922-36 and 620 in 1937-48.
10. RBI was established on 1st April, 1935 under the Reserve Bank of India Act, 1934 and was set up on the basis of the recommendations of Hilton Young Commission. Before establishment of RBI central banking functions were performed by imperial bank which was also performing the functions of a commercial bank.
11. Out of various applications received, RBI had granted licences to 10 banks. After a review of

- the experience gained on the functioning of the new banks in the private sector, in consultation with the Government, it has now been decided to revise the licensing guidelines.
12. Narasimham Committee was set up by Government of India to (i) examine the existing structure of the financial system and its various components (ii) to make recommendations for improving the efficiency and effectiveness of the system with particular reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions (iii) to make recommendations for improving and modernising the organised systems and procedures as well as managerial policies (iv) for infusing greater competitive viability into the system so as to enable the banks and financial institutions to respond more effectively to the emerging credit needs of the economy and other related matters. Government of India and RBI have accepted many recommendations of the Committee and taken steps to implement it.
  13. The other related functions of commercial banks are set out in clause (a) of sub section (1) of Section 8 of Banking Regulation, 1949. Narasimham Committee was set up by Government of India to (i) examine the existing structure of the financial system and its various components (ii) to make recommendations for improving the efficiency and effectiveness of the system with particular reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions (iii) to make recommendations for improving and modernising the organised systems and procedures as well as managerial policies (iv) for infusing greater competitive viability into the system so as to enable the banks and financial institutions to respond more effectively to the emerging credit needs of the economy and other related matters. Government of India and RBI have accepted many recommendations of the Committee and taken steps to implement it.
  14. The other important ancillary functions are set out in clause (a) to (i) of sub section (1) of Section 6 of BRA, 1949.
  15. It is the limit provided by the banks/Financial Institutions to a party without any depositing of primary security.
  16. It is an overdraft facility that is secured by assets pledged to the banks. The overdraft limit granted is dependent on the type of assets pledged and will be subject to the bank's approval.
  17. A cash credit is usually granted against the security of goods i.e., the agricultural or industrial products like rice, wheat, pulses, sugar, cotton, cotton textiles etc., in which the borrowing is granted.
  18. In case the bill is dishonoured by the acceptor, the bank recovers the amount from the customer who has discounted the bill.
  19. A non-performing asset is an asset which ceases to generate income for the banks. In other words, NPA means an advance or credit facility (i.e., term loan, cash credit, and overdraft, bills purchased and discounted and other accounts) in respect of which interest or instalment and principal remains overdue for the period of more than 90 days, with effect from 31st March, 2004. See Gupta, R.K. (2012), *Banking Law & Practice*, 2nd edn., Allahabad: Modern Law Publications.
  20. In 1981, a Committee under the Chairmanship of Shri T. Tiwari also examined the legal and other difficulties faced by banks and financial institutions and suggested remedial measures including changes in law.

21. The setting up of Special Tribunals was an important step in the implementation of the Report of Narasimham Committee. On 30th September, 1990 more than fifteen lakhs of cases filed by the public sector banks and about 304 cases filed by the financial institutions were pending in various courts, recovery of debts involved more than Rs.5622 crores in dues of Public Sector Banks and about Rs.391 crores of dues of the financial institutions.
22. For more details see *Neel Oil Industries v. Union of India* 1(2016)BC622 (DB) Guj.; *United Bank of India v. Satyawati Tondon and Ors.* AIR 2010 SC3413
23. The act is basically divided into three chapters:
  - " Enforcement of Security Interest.
  - " Reconstruction of Financial Assets & Formation of Asset Reconstruction Company
  - " Securitization of Financial Assets.
24. Sec. 2(z) of the Act defines securitisation. "securitisation" means acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise;
25. 2004(4) SCC 311
26. In *Sushil Kumar Agarwal v. Allahabad Bank* (2004)2BC94 court held that a bank can resort to its remedy under DRT Act and also at the same under S. 13(4) of the Securitisation Act.
27. This may be done either by the company or the tribunal suo moto.
28. The creditor has to furnish an affidavit stating that the debt is proportional to the property being possessed, the borrower has indeed defaulted in payment of the debt, the borrower has created a security interest over the property, the borrower has been served a 60 days' notice before taking any action under the act etc. These requirements have been laid down to ensure that there is no action on the part of the bank which is not justified. If the bank takes any action with the assistance of the District Magistrate based on false allegation, it can be held accountable later on.
29. Such cognizance can be taken only by a court not inferior to a Metropolitan Magistrate/ Judicial Magistrate.
30. The Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Bill, 2016 was introduced by the Minister of Finance, Mr. Arun Jaitley.
31. *Indian Express*, August 2, 2016.
32. For more details see [www.prsindia.org/billtrack/the-enforcement-of-security-interest-and-recovery-of-debts-laws-and-miscellaneous-provisions-amendment-bill-2016-4279/](http://www.prsindia.org/billtrack/the-enforcement-of-security-interest-and-recovery-of-debts-laws-and-miscellaneous-provisions-amendment-bill-2016-4279/)
33. The Insolvency and Bankruptcy Code, 2016 is the bankruptcy law of India which seeks to consolidate the existing framework by creating a single law for insolvency and bankruptcy. The Insolvency and Bankruptcy Code, 2015 was introduced in Lok Sabha in December 2015. It was passed by Lok Sabha on 5May 2016.



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