



SARFESI ACT, 2002: A CRITICAL ANALYSIS

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Introduction

Debt or asset securitization is one of the latest techniques which financial markets have been witnessing. Under asset securitization, a financial institution pools and packages individual loans and receivables, creates securities against them, get them rated and sells them to investors in a market. Thus, asset securitization is nothing but a process of stimulating assets into securities and securities into liquidity on an ongoing basis, increasing thereby turnover of business and profits, while also providing for flexibility in yield, pricing, pattern, size, risks and marketability of instruments.

Development of the SARFAESI Act

The first structured asset securitization occurred in 1970 in the United States in which securities were backed by a pool of mortgage loans. These pools for security were then sold in the form of certificates to the investors by putting similar securities together. From 1970 to 2000, the securities backed by assets other than mortgage has increased to almost \$60 billion. The Financial crisis of 2008 has taken a toll on business all over the world. Post-crisis analysis showed inadequate understanding and pricing of risks inherent in the process of risk transformation. This further lead to the

present situation in which India had to develop its own securitisation policy. The previous legislation enacted for recovery of the default loans was Recovery of Debts due to Banks and Financial institutions Act, 1993. SARFAESI Act, 2002 was passed after the recommendations of the Narsimham Committee – I were submitted to the government. This act had created the forums such as Debt Recovery Tribunals and Debt Recovery Appellate Tribunals for expeditious adjudication of disputes with regard to ever increasing non-recovered dues. However, there were several loopholes in the act and these loopholes were mis-used by the borrowers as well as the lawyers. This led to the government introspect the act and this another committee under Mr. Andhyarujina was appointed to examine banking sector reforms and consideration to changes in the legal system. With a view to formalize the operations of the securitization market in India and to ensure financial discipline and control in respect of the rights and obligation of the players, the legislature passed SARFAESI Act, 2002 which overrides previous Recovery of Debts due to Banks and Financial Institution Act, 1993[1] which is used as an effective tool by banks for bad loans and NPA (Non-performing assets). It is only possible when such NPAs are backed by hypothecation, mortgage or assignment. It aims to regulate securitization and reconstruction of financial assets and enforcement of security interest. It is only effective in case of secured loans where banks can enforce underlying security and the only exception is agricultural land. Another feature of this act which



removes intervention of Courts in this procedure makes it speedy and swift unless the security is invalid or fraudulent.

Operation of securitization under SARFAESI Act-

Securitization of assets involves a lending institution termed as Originator, whose loans and receivables will be converted into securities and a trust or Special Purpose Vehicle (SPV), through which the former will liquefy its assets. The Originator picks up a pool of assets which are similar in nature from the balance sheet and passes them on to the SPV through a pass through transaction. It is then converted into marketable securities for investment. The resultant cash flow will enable Originator to create further assets and periodical cash flows from the underlying collaterals by the way of repayment of loans and interest payments, will enable the SPV pay off its obligations of principal and interest to its debtors.

The provisions of this Act to override other laws is dealt in Section 35 which states that notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument have effect by virtue of any instrument have effect by virtue of any such law.

Objectives and Application of SARFAESI Act, 2002

The Financial Sector has been one of the key drivers in India’s effort to achieve its success in rapidly developing its

economy. While the banking industry in India is progressively complying with the international norms and accounting practices, there are certain areas in which the banking and financial sector require legal framework. In India, banks and financial institutes lack the power to take possession of securities and sell them which has resulted into slow pace of recovery of defaulting loans and mounting level of NPAs of banks and financial institutions. Acting on the suggestions given by two committees, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 came into the picture. This will enable the banks and other financial institutes to realize long-term assets, manage problem of liquidity, asset liability mismatches and improve recovery by exercising powers to take possession of securities, sell them and reduce non-performing assets by adopting measures for recovery or reconstruction.

Features of SARFAESI Act, 2002-

SARFAESI Act is Procedural in nature – This act is procedural in nature and lays a procedure for providing remedy of enforcement of security interest in secured assets, not through Court but by the secured creditor directly with the intervention of the Tribunal and Appellate Tribunal are not relevant for holding the Act is not of procedural nature [2].Retrospective provisions of SARFAESI Act- The provisions of this Act have been held to be retroactive in nature. The language used by the legislature in this Act is more than sufficient to show the intention of the



legislature to include the transactions of loan already entered into on the date when the Act came into force and therefore, merely because in sub-section (2) of the Section 13 there is a use of words “makes any default”, it cannot be read that the Act would not apply to the loan transaction and security created prior to the Act came into force. If such interpretation is given, it will frustrate the very intention of the legislature and also nullify the effect and operation of number of provisions of this Act. As such the Act intends to cover up all the transactions of loan already entered into the subject to the provisions within the period of limitation and the defaults in making repayment and the debts already classified as non-performing assets and such future contingencies too. Constitutional validity of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002- The constitutional validity of this Act has been upheld by the Supreme Court. There was failure on the part of borrower to discharge his liability in full within the period specified. Notice of 60 days as required was given. After measures under Section 13(4) are taken, mechanism provided under Section 17 of the Act is for the borrower to approach Debt Recovery Tribunal (DRT). On measures taken under Section 13(4) before the date of sale/auction of property, it would be open to the borrower to file appeal (petition) under Section 17 of Act before DRT. Borrowers would get reasonably fair deal and opportunity to get matter adjudicated upon before DRT. Impugned provisions of the Act were not unconstitutional as the object of the Act is to achieve speedier

recovery of dues declared as NPAs and better availability of capital liquidity and resources to help in growth of the economy of the country and welfare of the people in general to save public interest. The Constitutional validity of the Act and its provision was upheld except Section 17(2) of Act, which was declared Ultra virus Article 14 of Constitution. Action under SARFAESI Act during pendency of civil suit- During pendency of the bank’s civil suit, the bank can resort to simultaneous action under Section 13(4) of the Act [3].

Writ Jurisdiction- The remedy of appeal is available under the Act against actions relating to recoveries of dues of banks and financial institutions. Hence, it is not necessary to resort to writ jurisdiction under Article 226 of the Constitution. Section 13(4)(d) gives power to creditor to require the borrower to pay to the secured creditor a sum of money sufficient to discharge the secured debt such notice is given under Section 13(2). The action to be taken is contemplated under Section 13(4)(d) of the Act. The order passed by the DRT directing bank to proceed under the section during pendency of the petition was upheld. Can Co-operative Banks take action under SARFAESI Act- The provisions of this Act enabling co-operative banks to take resort to the Act cannot be challenged on the ground that members of co-operative banks are governed by the provisions of the bye-laws which inter-alia, provide for filing of suits before the Nominee, which cannot be nullified by the provisions of the present Act. Validity of Securitization Act so far as inclusion of co-operative banks is concerned cannot be challenged



on the ground that since provisions for recovery by co-operative bank is already made under Gujarat Co-operative Societies Act and therefore remedy under any other law is excluded.

In Allahabad Bank Vs Bipin Behari Lal Srivastava & Ors. (2010 (1) DRTC 340, Allahabad Court held that Civil Courts cannot grant injunction restraining the bank from taking measures under the SARFAESI Act as the same is barred under Section 34 of the Act.

In Mardia Chemicals Vs. Union Of India AIR 2004 SC 2371, the Apex Court while rejecting all the contentions acknowledged that NPAs¹ due from industrial units is a serious issue. While the Court accepted the recovery of debts due to Banks and Financial Institutions Act deals essentially with the same subject matter the court stated that it is widely accepted fact that the legislation, has not been very successful in dealing with the problems of NPAs.

“It is to be noted that things in the concerned spheres are desired to move faster. In the present day global economy it may be difficult to stick to old and conventional methods of financing and recovery of dues. Hence, in our view it cannot be said that a step towards securitization of the debts and to evolve means for faster recovery of the NPAs was not called for or that it was superimposition of undesired law since one legislation was already operating in the field namely the Recovery of Debts due to Bank and Financial Institutions

Act”

The Court further held “NPAs problem is an important issue regarding the growth of the economy in general and the financial sector in particular, the fact that NPAs. Have reached to an alarming proportion was noted by several committees and institutions and dealing with financial sector.

But certainly what must be kept in mind is that law should not be in derogation of the rights which are guaranteed to the people under the Constitution. The procedure should also be fair and reasonable though it may vary looking to the different situations needed to be tackled and object sought to be achieved. At the very outset the court observed that there is a need for modern enforcement laws and speedy enforcement laws and there has been shift in paradigm on the issue of enforcement laws which have increasingly becoming lender friendly. The court held “in such a situation there is a need for change in approach towards enforcement of the security interest law and the act cannot be held to be ultra virus merely because it allows the secured creditors to enforce their rights without the intervention of a Judicial authority.

“the action of the secured creditor is alleged to be fraudulent or their claim may be so absurd and untenable which may not require any probe whatsoever or to say precisely to the extent the scope is permissible to bring an action in the civil court in the cases of English mortgage.

¹ Non Performing Assets.



So view it is imposed while approaching the adjudicating authority of first instance, not in appeal, there is no determination of the amount due as yet the secured assets or its management with transferable interest is already taken over and under control of the secured creditor, no special reason for double security in respect of an amount yet to be determined and settled 75% of the amount claimed by no means would be a merger amount will leave the borrower in a position where it would not be possible for him to raise any fund to make deposit of 75% of the underdetermined demand. For the above reasons the court held Section 17(2) of the Act is unreasonable, arbitrary and violative of Article 14 of the Constitution. So 2004 amendment came.

Exemptions from Enforcement:

1. Lien
2. Pledge
3. Security in Air Craft's/ Shipping Vessels
4. Conditional Sale/ Hire Purchase/ Lease
5. Unpaid Sellers Right
6. Security Interest in Agricultural land
7. Properties not liable for attachment
8. Any Financial Asset: not exceeding Rs. 1 Lakh or where the amount due is less than 20 % of the Principal Amount and Interest.

Methods of Recovery under SARFAESI Act

According to this act, the registration and regulation of securitization companies or reconstruction companies is done by RBI. These companies are authorized to raise funds by issuing security receipts to qualified institutional buyers (QIBs),

empowering banks and FIs to take possession of securities given for financial assistance and sell or lease the same to take over management in the event of default.

This act makes provisions for two main methods of recovery of the NPAs as follows:

Securitization: Securitization is the process of issuing marketable securities backed by a pool of existing assets such as auto or home loans. After an asset is converted into a marketable security, it is sold. A securitization company or reconstruction company may raise funds from only the QIB (Qualified Institutional Buyers) by forming schemes for acquiring financial assets.

Asset Reconstruction: Enacting SARFAESI Act has given birth to the Asset Reconstruction Companies in India. It can be done by either proper management of the business of the borrower, or by taking over it or by selling a part or whole of the business or by rescheduling of payment of debts payable by the borrower enforcement of security interest in accordance with the provisions of this Act.

[1] Garlon Polyfab Industries v. State Bank of India (2003) 3 BC 626

[2] Apex Electrical Ltd. v. ICICI Bank Ltd., 2003 CLC 1323, (Guj.)

[3] Sushil Kumar Agarwal v. Allahabad Bank, (2004) 2 BC 94

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