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Introduction

The financial sector has played a vital role in India's rapid economic development. However, our existing legal framework for business transactions has lagged behind evolving commercial practices and changes in the banking sector. Consequently, loan recovery rates have been poor, leading to an increase in nonperforming assets at banks and other financial institutions.

The Central Government set up the Narasimham Committees I and II, along with the Andhyarujina Committee, to examine reforms in the banking sector. These committees evaluated the need for legal framework changes in these domains. They suggested new regulations allowing financial institutions to hold and sell securities promptly, bypassing court involvement, leading to the formation of the SARFAESI Act, 2002.

The SARFAESI Act of 2002 empowers banks in India to acquire and sell the collateral provided by defaulting borrowers without court intervention, enabling them to significantly reduce non-performing assets (NPAs). Abbreviated as SARFAESI, this statute grants banks the authority to seize and auction the collateral in case of borrower default.

Insight on SARFAESI Act 2002

The SARFAESI Act is described as legislation that oversees the securitization and reconstruction of financial assets, along with the enforcement of security interests. It also mandates the creation of a centralized database of property rights-related security interests and addresses related or incidental issues.

The SARFAESI Act was introduced with the aim of enabling banks and other financial institutions (FIs) to address NPAs without requiring court intervention. NPAs are defined under Section 2(1) of the Act and pertain to financial institutions operating in India as notified by the government. The Act outlines two main approaches for NPA recovery: acquiring the borrower's secured assets (with rights to lease, assign, or resell them) or assuming control of the borrower's management or company until the NPA is resolved. Moreover, the Act permits banks and FIs to sell financial assets to Asset Reconstruction Companies (ARCs), subject to compliance with the Reserve Bank of India's (RBI) regulations and recommendations.

The secured creditor's entitlement to enforce the security interest as per the Act comes into effect only after the borrower's account has been classified as an NPA in the secured creditor's (banks or financial institutions') accounting records, as per RBI guidelines. The secured creditor is required to serve the borrower with a 60-day notice, requesting repayment of the outstanding amount and specifying the assets on which the secured creditor intends to enforce its security interest.

If the borrower fails to meet its obligations to the secured creditors after the expiry of the 60-day notice period, the secured creditor may enforce the security interest over the secured assets by:

1. Assuming control of the secured assets;

2. Taking over management of the secured assets, including the right to transfer them through lease, assignment, or sale;

3. Appointing someone to manage the secured assets; and

4. Compelling any person who has acquired any of the borrower’s secured assets to pay the amounts necessary to settle the debt.

If a secured creditor cannot recover the entire amount owed through the enforcement of security interest over the secured assets, they may pursue recovery of the remaining amounts through the Debts Recovery Tribunal (DRT) or the appropriate court. A secured creditor may pursue remedies under both the SARFAESI Act and the DRT simultaneously. For the SARFAESI Act to be applicable, the borrower’s account must be classified as an NPA by the secured creditor and have an outstanding balance of INR 100,000 or more. Additionally, certain cases may not be subject to the Act's requirements, as outlined in Section 31 of the SARFAESI Act, such as accounts where the remaining debt is less than 20% of the initial principal amount and interest.

Elements of SARFAESI Act

The SARFAESI Act of 2002 is applicable nationwide in India. It modifies the following four laws:

1. Indian Stamp Act, 1899.

2. The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI).

3. The Depositories Act, 1996.

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

These modifications cover matters connected or incidental to these laws.

Aim of SARFAESI Act

The SARFAESI Act aims to achieve two primary goals:

1. Facilitating the timely and efficient recovery of non-performing assets (NPAs) held by financial institutions and banks.

2. Granting financial organizations and banks the authority to auction residential and commercial assets in case of borrower default on their debts.

Need for SARFAESI Act

The hallmark of the Indian industry is marked by economic indiscipline or financial illiteracy. The persistent rise in Non-Performing Assets (NPAs), a euphemism for problematic loans, prompted the enactment of the Recoveries of Debts due to Banks and Financial Institutions Act, 1993. This legislation established a specialized Debt Recovery Tribunal (DRT), as defined in Section 2(1)(i) of the Act, to address NPAs. However, while this initiative failed to expedite the recovery process, the stringent civil law requirements significantly diminished the effectiveness of asset attachment and foreclosure for loan security. Moreover, banks and financial institutions found their balance sheets deteriorating due to substantial mandated provisions for non-performing assets (NPAs).

Acknowledging that one in every five borrowers defaults on their loans, the government felt compelled to establish effective mechanisms for debt recovery and foreclosure of security. Thus, the SARFAESI Act, 2002 (the Securitisation Act), aims to achieve these dual objectives while also offering a comprehensive legal framework for asset securitisation and reconstruction.

Important case law

Facts: IDBI Bank issued a notice against Mardia for defaulting on payments. Mardia appealed in court, where multiple similar petitions were consolidated and addressed together.

Issue: The court needed to determine if challenging the SARFAESI Act on the basis of its necessity at the time of enactment, especially when another statute was already in place, was permissible. Additionally, the constitutionality of Section 13 of the Act and the fairness and reasonableness of Section 17, particularly Section 17(2), were under scrutiny.

Outcome: The Supreme Court affirmed the constitutional validity of the Act, acknowledging that while certain provisions may seem stringent to some borrowers, they serve the Act's objective of expediting recovery of dues declared as NPAs and enhancing capital liquidity for the nation's economic growth and borrowers' benefit. Additionally, the Court allowed debtors to appeal against lending institutions at the DRT without needing to deposit 75% of the outstanding debt. If the tribunal does not grant a stay order, the bank is authorized to sell the assets.

Conclusion

In recent years, the SARFAESI Act, 2002 has undergone significant enhancements to align with statutory demands. Judicial intervention has historically mitigated uncertainties regarding legislative application. Consequently, the Supreme Court's recognition of substantial advancements in the SARFAESI Act, 2002 is deemed accurate. Recognized as crucial for economic progress, expanding the Act's scope is seen as imperative for bolstering the nation's financial institutions.