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## **Securitization in India with the perspective of commercial banks**

**Rajas Jani**

LLM Student, Symbiosis Law School, Hyderabad, Telangana, India

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### **Abstract**

Securitization is the method of taking an illiquid asset or collection of assets and converting it (or them) into a security through financial engineering is securitization. This process of Securitization gained some light in India in the early 1990s. The law regarding securitization was enacted in the form of “The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI)”. The paper talks about the role of Non-Performing Assets in banking sector. The paper talks about the link between SARFAESI Act and the commercial banks and the process of bank securitization. The paper talks about the various amendments of SARFAESI Act and some drawbacks which are faced by the Banks through this legislation.

**Keywords:** SARFAESI, commercial banks, financial

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### **Introduction**

Securitization means to generate some security in a monetary transaction. Securitization is a practice where the securities or the assets are sold to the special remote vehicle for some instant cash in return wherein this cash is used in to support the securities issued by the Special Remote Vehicle. Securitization is a process where the company combines its different assets to create a financial instrument which is then sold to the investors. The investors receive interest for investing in such securities. This practice increases liquidity in the market. It is the main instrument for the companies especially bank and financial companies to raise money from the market.

India experienced the first securitization like process in the starting of 1990s. There were mostly secured loans at that time mainly against auto loans and that remained the largest. In spite of “shallow” market the country has noticed a multiple range of securitization trades. Housing sector is the sector which has seen an upward direction in the few years. In the last few years in India the securitization market has evolved exponentially. But the main issue for the lacking of the diversity in the market is not because the market is new but it’s because of lack of proper rules and regulations by the central bank.

The first law regarding securitization was “The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI)”. This was the most important legislation related to securitization. It had a massive impact on the process of securitization. The main aim of the SARFAESI was to authorize the secured creditors to impose security on movable and immovable without the interference of the court <sup>[1]</sup>. Before the introduction of this act the process regarding the security was very slow and stiff. In the process of liquidation a long process was to be followed by the secured creditors thus depreciating the value of the asset. The SARFAESI has helped the creditors in recovery of the loan without much intervention of the court. This act is best suitable in today’s scenario as it eases the mobility of the money which can help the development of the country. Before introduction of this act it was a difficult process

for the secured creditors to recover their money which lead to financial stability in the country. The Creditors can be secured or unsecured or can be operational or financial. SARFAESI act is mainly concerned with secured creditors.

The SARFAESI Act also allows the institutions to enforce the security given by the borrower when the borrower defaults his payment by mortgage or hypothecation. The borrower is provided with the time of 60 days to clear of his debts, if the borrower fails to pay off his dues within this time the secured creditor may take the possession of the security and can realise the asset by sale, hypothecation or mortgage. Secured Creditor can also take over the management of the company. Before the amendment of SARFAESI the creditor only had the power to realise the asset but it was not permitted for him to take over the management of the organisation. If the debtors pay back the amount to the creditor before the realisation of the asset the debtor can take back the possession of his asset from the creditor <sup>[2]</sup>.

### **Securitization and India**

In the early 1990s, securitization began in India and developed slowly but gradually, creating annual issuance volumes ranging from USD 3 billion to USD 6 billion in recent years. Often, legislative and tax problems have posed hurdles to the growth of the industry, but the market now seems to have overcome those obstacles. Two types of transaction mechanisms compose the market: direct assignments and pass-through certificates. In most countries, direct assignments resemble whole loan transactions, while pass-through certificates involve the familiar feature of a special-purpose fund that retains the properties of a contract and acts as the bond issuer of the transaction. The Reserve Bank of India's policies requires certain lenders in designated "priority sectors" to meet lending volume targets. Over the past several years, these requirements have encouraged direct assignment transactions, but now the market is likely to move back to greater use of the pass-through structure.

India's infrastructure needs up to Rs 43 trillion of investments up to 2022. CRISIL puts the debt demand of the infrastructure sector at Rs 30 trillion. Globally, infrastructure is usually funded by private investors, with matching long-term liabilities and risk-return expectations; in India, banks have been the engine of infrastructure funding.

India's banking industry, however, is under strain, as banks, weighed down by bad loans and poor profitability, are exceeding their infrastructure lending exposure limits. The issue is more acute among public sector banks (PSBs). After 2016, nearly 88 percent of the banking sector's non-performing assets (NPAs) have been accumulated by PSBs, compared to 70 percent foundation of cash. The new Basel III requirements for bank capital, introduced in 2019, are compounding the banking sector's problems. In order to meet these norms, numerous studies have projected that India's banking sector requires between Rs 2.5 trillion and Rs 6.0 trillion in cash.

Securitization helps an investor to sell a portfolio of reserves from which shares on the bond market are sold. This frees up money, especially when carried out by the selling of pass-through shares, which provides access to bond market investors, such as insurance companies, hedge funds and mutual funds. In order to better meet the risk-return requirements of institutional investors in India, infrastructure securitized documents should be designed as a complete offer, backed by credit improvements offered by internal and external mechanisms, since India's securitization sector is in the early stages of growth. For an asset pool containing non-thermal, operational for originating banks, power reserves, infrastructure-securitized documents are of positive importance. Important considerations would, however, need to be tackled in order to facilitate the substantial uptake in India of infrastructure-securitized documents. These considerations consist of properly chosen equity pools, floating-to-fixed interest rate risk management structures for infrastructure assets, and structural and tracking mechanisms<sup>[3]</sup>.

### **Non-Performing Assets in banking sector**

The magnitude of non-performing assets (NPAs) in its banking system is perhaps the strongest indicator of the financial stability and robustness of a government. In India, a non-performing advance is commonly defined as one with interest or principal repayment instalment unpaid for at least two quarters of a period. For individual banks, as well as the financial system of a country, NPAs form a major drag. They reflect the low quality of the bank's reserves and have to be provided for capital use. They clearly have an immense detrimental effect on the viability of a bank and can lead to a complete erosion of its asset base. In banking and indeed in financial stability around the world, NPAs are a crucial problem. Banks from developing countries such as Japan to emerging markets such as China are both tackling the question of managing and reducing their burgeoning NPA shares. Indian banks had their share of NPAs and today many struggle with them. Several banks with large non-performing assets have been saddled by decades of government-controlled banking with politically and socially influenced lending, mostly marked by cronyism, favoritism and lack of openness. Some are falling under their weight, like the three pointed out by the Verma committee. All concerns key to the banking sector reform process and policies are acknowledging these NPAs, taking the hit on the

investments, and recapitalizing banks to survive the write-downs<sup>[4]</sup>.

### **Bank Securitization**

Banks are inescapable and essential to a nation's financial growth. For investors and creditors, banks serve as intermediaries. The basic duties of banks are the receipt of deposits from donors and the lending of loans to borrowers. They have deposits of interest and receive interest for advances. In this way, banks serve as a vital link between borrowers and investors. If the creditors fail to refund the principal and the integral sum as negotiated, this tie divides. These findings for the banking sector in Non-Performing Assets. The money of the loaning broker is locked up at the point where the cash is kept up in non-performing capital, allowing credit enhancement and financial exercises to become paralyzed. When using creditors' loans, the banks claim securities so that they can auction the securities and reclaim the sum. In this approach, the bank faces a large amount of problems usually related to the nation's fundamental laws that are exceedingly uncomfortable. It might take years to obtain an announcement. Before 2002, banks in India had no choice to recoup their responsibility by maintaining protection via a court/tribunal. Bearing in mind the overarching objective of making the framework easier for the recovery of credits or NPAs from the defaulters, the Narasimham Committee mandated the detection and elimination of NPAs to be regarded as a national priority because NPA directs towards the bank's credit risk and its capital allocation effectiveness. For this, they proposed the structure of the "Securitization and Rehabilitation of Financial Assets and Enforcement of Security Interest (SARFAESI) Act 2002", where the NPAs could be retrieved from the defaulter without court intercession by providing the advantages of Indian creditors. Through upgrading the processes, RBI has taken several steps to reduce the extent of NPAs in the management of an account section. Because of the rise in NPAs amount, the way to borrow often gets ostentations. Legal recovery of advances is the biggest factor that would help borrowing and increase the benefit of banks. The "IBC (Insolvency and Bankruptcy Code)" has been ordered and the "SARFAESI (Securitization and Rehabilitation of Financial Assets and Enforcement of Security Interest) Act" and "RDBFI (Recovery of Debts because of Banks and Financial Institutions)" have been amended to strengthen the determination or recovery of bank deposits by the. In addition, six new "Debt Recovery Tribunals (DRTs)" have been formed to increase recovery.

### **SARFAESI Act and Commercial Banks**

Banks and Financial Institutions are given power under the SARFAESI Act 2002 to "seize" and "confiscate" the asset of the defaulter. The defaulter is served with the notice of 60 days by the banks to clear off his dues and liabilities. After the failure of defaulter to clear his dues, the bank can take following steps as per the requirements. The banks can take power of the asset and can sale or mortgage the asset. This legislation also provides to establish an Asset Reconstruction Companies which is been regulated by Reserve bank of India. The Financial assets are sold by the banks to these Reconstruction companies. This transaction is observed by the Reserve Bank of India. RBI is the supreme authority in conducting this process. From registration of Asset Reconstruction Companies and securitization companies to

regulation of it everything is monitored by the Reserve Bank of India <sup>[5]</sup>.

### **Mardia Chemicals Ltd vs Union of India**

This case is one of the landmark cases while interpretation of the process of securitization. In this case it was contended the banks and financial institutions were working arbitrarily and without providing any suitable procedures of dispute resolution. The act only talks about the procedure for taking control of the security or the management of the company but was silent on the part of the borrower.

The main issues of the case were (1) the need of this statute when a statute relating to this matter was already in force (2) Section 13 was unconstitutional (3) the deposit of 75% of amount was valid or not.

The Supreme Court decided in this case that after the borrower is served with the 60 days notice by the creditor the borrower has the right to raise objections against the notice and the creditor must give a reply to objection of the borrower. If the objections are rejected by the creditor then the reason of not accepting the objections should be properly communicated to the borrower. The borrower can file an appeal before the sale or mortgage of asset before the Debt Recovery Tribunal. It also decided that it is not required to deposit 75% of the amount before an appeal as the amount is very vague and unfair.

### **M/s Travancore vs Union of India**

It was held in this case that while taking the Control of the asset the secured creditor should not use illegal means which implies the creditor should not take the asset forcibly. The Creditors should file an application to Chief Metropolitan Magistrate or the District Magistrate in taking the possession of the asset. While doing so the borrower is not heard by the CMM or DM. The main job of the CMM and DM is to assist in handing over the possession and control of the asset of the borrower to the creditor legally. The authority cannot solve the dispute of the creditor and debtor as it will nullify the provisions of the SARFAESI Act. The main aim of the authority is to assist the creditor in obtaining the control of the asset <sup>[6]</sup>.

### **Asset Reconstruction Company and Qualified Institutional Buyer**

The aim of an Asset Reconstruction Company (ARC) is to rebuild the assets by repackaging the Banks/FI financial assets to make them marketable in compliance with the provisions of the Act. Due to the challenge of NPAs and as a consequence of the decline in the recovery of these organisations, the need for ARC has emerged in India. These organizations have struggled to resolve the question of the NPA itself and there is also a need for third party involvement. ARC's are the businesses that are intended to solve this problem. ARC is going to buy the NPA's from the Bank/FI, repackage them in the required denomination to make them homogeneous and sell them. The NPA is distributed at a mutually agreed price by the Bank/FI. In one stroke, the Bank/FI will clear the NPAs from their balance sheet. The ARC may issue debentures and position them with the Qualified Institutional Buyer in compliance with the provisions of sections 5 to 7 of the Act <sup>[7]</sup>.

Once the loans or debt pool is turned into shares that are marketable, SPVs advertise to sell in the market with their debt

securitised commodity, but they do not sell them to anyone. SPVs market shares only to buyers who have clarified their position. The Qualified Institutional Buyers (QIB) are all these clearing groups. Investors/QIBs receive fixed or floating interest rates from the SPV account, which is repaid by the cash flows produced from the asset portfolio <sup>[8]</sup>.

### **Amendments in SARFAESI Act**

The SARFAESI Act requires secured leasers, following a failure in repayment, to claim control of a promise against which a credit has been issued. With the assistance of the District Magistrate, this process is tried and does not require the intercession of the courts or tribunals. The Bill provides that the District Magistrate shall complete this process within 30 days.

The Bill engages the District Magistrate in extension to aid banks in taking power of an institution's administration, on the off risk that the organization will not repay advances. This will be done on the off chance that the banks will turn to valuation deals over their exceptional task, and thus hold a share of at least 51 percent in the company.

To preserve lists of exchanges identified with secured services, the Act establishes a focal register. The Bill creates a focal archive for this focal register to consolidate records of property enlisted under various enrolment structures. This requires the addition of registrations under the Companies Act, 2013, the Registration Act, 1908 and the Motor Vehicles Act, 1988.

The Bill specifies that, until it is registered with the Focal Registry, protected leasers will not be allowed to claim possession of the pledge. Encourage these banks to have need over others in reimbursement of service after enlistment of protection premium.

The Reserve Bank of India (RBI) was engaged by the Act to evaluate the announcements and any data associated with their business by Asset Reconstruction Companies. In addition, the Bill requires the RBI to investigate and analyze these entities in detail. If the organization neglects to obey any headings provided by it, the RBI may sanction an organization.

The Bill provides that the stamp duty for resource replication organisations would not be paid on exchanges attempted for the sale of monetary goods. Advances and insurance are built into budgetary services <sup>[9]</sup>.

### **Problems under SARFAESI ACT**

A receipt of securitization (SR) confers a right of title or interest on the financial properties used in the securitization to its holder. In the case of 'Pay through Securities' with separate tranches, the term is not technically insufficient. The SARFAESI Act has been designed to encourage Qualified Institutional Buyers (QIBs) to issue and retain security receipts (SR). It does not include NBFCs or other organisations, unless defined as a financial institution (FI) by the central government. Securities demand is limited to short tenor papers with the best scores. Credit risk, sovereign risk, collateral deterioration risk, regulatory risk, prepayment risk, service efficiency risk, exchange counterparty risk and financial guarantor risk are the numerous risks involved in securitization.

### **Issues by Bank**

#### **1. Sale of Secured Asset**

In general, after taking custody of the land, the banks find it an arduous process to undertake measures to sell the assets. Since

there is no specific provision to purchase the property for its own sake, without recourse to wipe the debt off its accounts, the bank may keep ownership. In the Civil Cases, the creditor may also engage in the sale and obtain the insured property with the approval of the judge. In this respect, in the SARFAESI Act and Laws, the Act did not make any clear provision.

## 2. Issues regarding Government payments

While the SARFAESI Act has an overarching impact on other rules, government arguments will prevail and the amount realized from purchases is always claimed by government authorities. Banks are bound to respect sales tax statements etc. except after the mortgage generated for the Bank due to the reform in the Selling Tax Act of different States and rulings of Higher Courts. However, if the following points are made as a basis for the exercise of those rights, it can give the bankers/creditors a great deal of relief. Government officials should explain that the argument applies to a pre-mortgage date for the benefit of the bank. In order to recover the dues, the authorities have taken all practicable steps within a fair period. The debtor has no other property/source other than the property mortgaged to the bank for the payment of government dues.

## 3. Intervention by Courts

Sometimes, High Courts interfere in the cases under the SARFAESI Act by entertaining Writs submitted by the aggrieved parties. While judgments of the Supreme Court have the consequence that one should opt for other modes only after exhausting the remedies prescribed under the respective law. Writs are filed generally in this case. (The forums prescribed under the Act for this reason are DRT and DRAT). As far as healing is concerned, this induces a great deal of delay. Such written pleas may be restrained by the Registry of the High Courts and the backlog of pending matters may be prevented to a certain degree <sup>[10]</sup>.

## Conclusion

At recent time many changes have been introduced in the banking sector of the country. Due to NPAs the bank were facing huge losses. SARFAESI Act expedited the process of recovery of secured assets by the bank. The introduction of SARFAESI has acted as assistance to the banks and financial institutions when they found it very difficult to realise the assets and to take control of the security for the purpose of sale. SARFAESI has been useful legislation specially for secured creditors.

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