

AN ANALYSIS OF THE DEBT RECOVERY SYSTEM

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ABSTRACT

Debt servicing is a prominent issue faced by all the developing countries, it is imperative that these countries have a robust mechanism to handle their overall debt and that their debt recovery systems are capable to handle the needs. Many recent legislations in India such as the DRT Act, The SARFAESI Act etc have come into place to cater these needs. The questions that remains is whether these reforms have achieved their goals, whether they are enough to address all concerns and what changes are required if any? Industry participants and RBI feel that they are lacking, hence a review of the system is warranted. This paper is descriptive of the challenges in Debt recovery in India.

Keywords: DRT, SARFAESI, Finance, Non-Performing Asset, Courts.

Introduction

India, as is the case with almost every developing country in the world, is afflicted with plenty of issues, for which there has been little, slow or no solution at all. And one of the main issues is related to enforcement of loan contracts, better known as debt recovery. This money is essentially sums that are borrowed from banks and financial institutions, which have not been paid despite repeated requests from the banks. This poses a major problem to the country, one of them being uncertainty of doing business in India. Uncertainty in cash flow is a major cause for the closure of many businesses in our country. It can have implications of affecting the business environment and lowering India's position and ranking in the World Bank's "Ease of Doing Business Index", which plays a very crucial role in the inflow of foreign funds into India. The sluggish courts system in India makes it a last resort for banks and financial institutions, which leads to a great delay in the final recovery, if at all it takes place.

This paper aims at giving a basic overview of the current situation of surmounting debt in India, and the steps being taken to ensure speedy and efficient recovery of debt in India. There are 2 primary legislations in this regard: (1) The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), and (2) The Recovery of Debts Due to Banks and Financial Institutions, 1993 (RDDB & FI Act). Further, the authors also elaborate the impact of debt recovery system with the RBI's stand on this.

Banking Sector and the Debt Problem In India

Bad Debts have been clogging up the Indian Banking system. India has been considered as "Asia's other bad debt headache". What was worse is that the end of Dr. Raghuram Rajan's tenure as the RBI Chief is only going to delay the process of any clean-up or progress in solving the debt crisis in India. The mess created so far is a result of years of business tycoons and politicians using their influence to procure 'cheap' loans from banks and financial institutions.

The problem doesn't just stop here. Even in written contract, where everything can be deciphered and codified clearly, the problem only increases. The terms and conditions of the loan agreement are the most important part of the Agreement, which many parties don't have a habit of reading or negotiating. They blindly accept these terms and conditions as though they are a standard form contract. In many situations, banks and financial institutions enter into agreements with customers which are null and void right from the very beginning of the relationship, thereby leading to a cancellation of the entire agreement and leaving the banks with little or no recourse.

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The SARFAESI Act provides for three alternative modes of reclamation, and they are: (1) Securitization, (2) Asset Reconstruction and (3) Security enforcement *sans* the assistance of a Court or a Tribunal. To briefly describe the procedure under the SARFAESI Act, it endows power on Banks and FIs to issue what are called demand notices to the borrower who has defaulted on the loan as well as the guarantor of the debt, calling upon either of them to discharge their amount owed to them in totality within 60 days from the date when the notice is served. Failure to perform on the notice empowers banks to take into custody the security against which the loan was granted and sell, assign, manage or appoint any person to manage the right to the security. However, proceedings under the Act cannot be initiated, if the secured asset is an agricultural property.

The key difference between the two Acts is that the SARFAESI Act allows for recovery without the intervention of judicial process and allows for recovery of only secured debts, while under the DRT Act, Banks and FIs can recover debts more than ten lakhs through DRTs and it is entitled to the doctrine of election, i.e., it doesn't restrict itself to secured or unsecured debts.

Further, the inception of DRTs and DRATs were to reduce the burden on the judiciary and to provide for an effective measure, but the problem only has been transferred to the DRTs, as per the Deshpande Committee Report, the ideal number of cases to be handled by any DRT at any given time was supposed to be 30, this number even in the initial stages were around 4000 in major cities. The success rates of DRTs have been pegged at below 25% which is a concern. Furthermore, DRTs got burdened with issues of state dues, dues of workmen and claims involving unsecured assets, the borrowers also stalled proceedings by raising claims against lenders in civil courts.

The most important case with regards to debt recovery is the case of *Union of India v Delhi High Court Bar Assoc, & Ors* in which the constitutionality of the RDDB & FI Act 1993 was challenged. The Delhi High court held the act to be unconstitutional but the Supreme Court held the Act to be valid and ordered certain changes. Although the legislature intended to have a creditor friendly approach, the courts have interpreted some of the provisions to protect the debtors, even though CPC doesn't apply and the proceedings are summary in nature, court has reiterated that natural justice principles cannot be done away with, one example is the case of *Mathew Varghese vs. M. Amritha Kumar* in which the court has held that under rules 8 & 9 of SARFAESI Act notice to defaulter before sale of secured asset was held to be a mandatory provision.

Another problem which has arisen is the problem of frustration of jurisdiction of DRTs through filing of suits in Civil courts, the Supreme Court has held that consent is not necessary for transferring cases but another case has an opposite holding, successive cases have not clarified the stance. The concern raised was that the DRTs have summary proceedings and they are not equipped to address complex questions of law and questions of fraud and misrepresentation. Furthermore the 33 DRTs across India are ill-equipped to handle the quantum of cases, although the parliament has recognized this issue and has proposed to setup new DRTs, not much has materialized, even the existing DRTs are understaffed with many posts lying vacant. In recent times major changes have been made to overhaul the debt management, Credit Information Bureaus have been setup under the Credit Information Bureau Act of 2005. In any debt Industry, Credit information regarding credit worthiness and Credit rating plays a prominent part. Many Credit rating agencies have now come into existence and the practice of credit based on rating is slowly being adopted.

However India still has a long way to go, in adopting the same to any beneficial effect, In the USA every single member would invariably have a credit score and most people with a bad credit rating are denied any form of credit by the formal institutions. The entire procedure cannot be adopted in India, the credit rating industry in the USA is a private industry and it has caused many problems to the poor citizens due to faulty operations. Also on a principal level this system cannot be completely adopted without changes, the agriculture sector may not have a good credit rating and credit at any rate cannot be stopped there, this system should be focused on credit flow towards industries and high value individuals. Further it would be desirable if the Private Banks adopts this system with rigorous standards and the Public Sector Banks adopt this system with liberal standards taking into account the policy framework of the Central government. This however needs to be adopted and the credit based on collateral alone is not always a desirable given all the above observations. The Regulatory Impact assessment has leads to a conclusion that there are not sufficient tools to address the issues with the DRTs, there needs to be capacity building and transparency.

The Bankruptcy Code 2016: Unlocking the Locked Money

The Bankruptcy code was passed by the parliament in May 2016. It seeks to regulate the insolvency of both corporations and individuals and firms under one comprehensive code. With regard to corporate insolvency it involves a two-step process.

Firstly the Insolvency Resolution Process (IRP) and the Liquidation, to initiate the process the minimum default is 100000 which bring in a lot of defaults. Under the IRP the corporate lender can initiate proceedings under the NCLT after which a moratorium is issued or what is known as the calm period. Further a Resolution Professional is appointed, the management is then shifted from the debtors to the creditors. Further a creditor committee is constituted and decisions are taken by a 75% majority vote, a revival plan is thus created within 180 days. If 75% decide to go for liquidation or revival plan is not created within 180 days or NCLT rejects the plan then the liquidation of debtor's assets take place to service the credit. For individuals the threshold is set at 1000 and the debtors and creditors can opt voluntarily for a repayment plan failing which a Bankruptcy order will be forwarded.

Impact of The Debt Recovery System on Banks and the RBI's Stand

Till the enactment of the RDDL & FI act and subsequent establishment of DRTs and DRATs the banks were expected to file a civil suit under the civil procedural code. The job of the banks became easier only after the banks were given powers to confiscate secured assets through DRTs, this was the first creditor friendly legislation or mechanism put in place. The failure of DRTs would lead to all problems which are connected with NPAs there will be blocking of cash which would reduce liquidity of banks, bad debts reflect poorly on banks leading to loss of goodwill and further their investments, banks lose out on returns on investment and is also a negative opportunity cost, as they are losing out on future profits and potential good debts.

The banks auction the assets after advertising, they fix reserve price and non-refundable earnest money deposit is received from the successful bidder, there are a lot of peculiarities in this process and it has been found to be inefficient. In recent years the bad debts of major public sector undertakings have risen and RBI has taken note of the same, the previous Governor Raghuram Rajan had started a cleanup drive to manage NPAs in these banks. RBI has laid down firstly guidelines to categorize bad debts or NPAs into 3 categories, it has further laid down guidelines to address this situation through ARC (Asset Reconstruction Companies). The recovery volume is 13%, which means that banks cannot reduce rates, they are now forced to charge credit risk premium from corporations to the tune of 6% which shoots up the overall interests.

Further it can be noted that the DRTs do not follow the prescribed time limit, this erodes the values of the assets making it non-viable for the banks. The DRTs are not focusing on debt recovery with a commercial interest view point; rather it is focusing on other aspects and is delineating from the purpose. RBI has made several attempts in the recent months; it has introduced the Strategic Debt restructuring Scheme and the 5/25. Under these schemes Non-Performing assets of Banks subject to certain conditions can be converted to equity, the banks have been exempt from provisioning and restructuring subject to fulfilment of certain conditions. RBI has also conducted recently the cleanup process under which it sought to address the NPSs in major banks, in this regard a periodic and comprehensive analysis of the books of major banks took place and as expected it was found out that the quantum of bad debts were undervalued and RBI has taken measures to obtain an accurate estimate. RBI recently had found out that the leverage ratio of Major Public Sector banks were unsatisfactory and the Gross Non-performing Assets were at 4.6% to advances and overall stressed assets were at a ratio of 11% to advances.

- **Are DRT's Really Helping the Cause?**

Much debate has been going on about the efficacy of DRTs. There has much hue and cry about whether it is actually furthering the cause of speedy and efficient debt recovery. Some even say that they are a type of Non-Performing Asset (NPA). Industry views reveal that the recovery process is inefficient and often witness lack of robust participation in properties auctioned under DRTs. While the DRTs initially performed well in attaining their objective, their progress came to a halt when it the large and powerful borrowers began using their evasive tactics. This problem was essentially a jurisdictional conflict between DRTs and civil courts. However, the Apex Court ruled that "*such an independent suit filed by a borrower could not be transferred to the DRT without his consent since his right to approach a civil court cannot be taken away*". This decision raised fears among the banks and FIs since jurisdiction of the DRT could be easily side-stepped by the borrower filing an independent suit in civil court asking for the exact opposite of what the bank or the FI was asking for in the DRT. On the other hand, only one year later in 2007, the Apex Court revisited the same aspect in *State Bank of India v. Ranjan Chemicals Ltd.* and held that its "power to transfer a suit did not depend on the consent of the parties". There is some difficulty in reconciling this ruling with that of *ABS Marine*, considering the Court ordered the transfer of an independent suit on the ground that "it would avoid the duplication of evidence, counsel, expenses", among other factors.

Apart from this, there are other minor shortcomings too. For instance, the dues of workmen against the company, dues payable to the Government, and those payable to other unsecured creditors all would come to standstill before DRTs, thereby adding to the already piling cases before the DRT. Another shortcoming is the jurisdictional clash between High Court appointed Official Liquidators in winding up cases and the Recovery Officers of the DRTs. In such a scenario, the Official Liquidator, considering that they are appointed by a superior authority, would take possession all the assets belonging to secured creditors, who are before the DRTs. The High Court's also take offence on the actions of Recovery Officers, who would recover the entire money to repay the banks, thereby leaving peanuts for the other claimants, including credits such as the company's work men. These problems lead to amendments to the Act in 2000. As much as the 2000 amendment brought about some amount rationalization in the jurisdiction of the DRTs, it was insufficient to make the big borrowers submit to the jurisdiction of the DRTs easily. This resulted in the lenders suffering under the weight of NPAs.

Another problem, although minor, less frequent and general to the recovery process is illiquidity of the asset given as security and its specificity in value. What happens in the usual recovery process is that the bank recovers its dues by sale of the asset by publicly auctioning it. Further, it is mandatory for the bank to advertise the auction in the leading newspapers, after mentioning a reserve price, thereby inviting bidders for the asset. Before bidding, the bidders must deposit a refundable amount called the earnest money deposit (EMD), which could be 15% of the reserve price. Upon winning the auction the successful bidder has to pay the remaining amount within the period determined by the bank. If the bidder is unwilling to pay the amount he bid for, the EMD would not be returned. Subsequent to the bidding process, there is a 30 day window where the owner of the property/ asset can seek an injunction for the sale on the grounds of lower than expected price or lack of proper advertising of the asset for the auction. What usually happens is that the asset which is given as security is illiquid and is often very specific in value, thereby making it difficult to sell to anybody. Now assuming that the bank does get a lesser price for it, it may choose to settle for that price owing to its illiquidity and specificity. The owner may have the highest value in the asset, while it may mean absolutely nothing to the other prospective bidders.

Further, The Insolvency and Bankruptcy Code passed by the Lok Sabha in May 2016 envisages DRTs as the adjudicating authority for individuals and partnership firms. When originally set up, DRTs were expected to settle cases within a limit of 180 days. But experience and statistics tell us that judicial delay is as much of a problem in the DRTs as with other courts. The DRTs will have a tough time in coping with the additional responsibility of dealing with insolvencies and liquidations, apart from adjudicating on regular banking matters.

Conclusion

It has become clear that the rising debt problem in India is hurting the banking industry and the economy, the volume of Non-performing Assets have been steadily rising, the banks have been under valuing them, and banks have not been able to write them off of their books. RBI has taken note of this serious issue. The Debt recovery problem was somewhat eased by the passing of RDDL& FI Act and further eased by SARFAESI Act.

With regard to the first question, i.e. what the contribution of DRTs is to improve debt recovery, it can be concluded that the system is better than having recourse to civil proceedings, they are faster since they have summary proceedings but they are not capable of addressing complex questions of law in the area.

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- ✧ "Securitization is the process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities."
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