Evaluating the Effects of Lowering the SARFAESI Act Threshold on Loan Recovery Processes for NBFCs

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I. Abstract

When the RBI's Governor, Raghuram Rajan, took charge in 2013, "the gross and net Non-Performing Assets (NPAs) in the banking system had hit an alarming 4.2% and 2.2%, respectively, against an average of 2.6% and 1.2%, respectively, between 2009 and 2013."[1] This was a sign of a growing issue in the economy, later termed the "NPA Crisis", which occurred between 2015 and 2018 when "the gross NPAs of the Indian banking system reached 11.5% of the total advances of the banking sector. The gross NPAs of PSBs were reportedly as high as 14.6% while net NPAs had reached about 8.5%."[2] Various legislations existed to address this issue, such as the Lok Adalat, Debt Recovery Tribunal and the SARFAESI Act. While substantial measures by the government resolved the crisis, there was one sector in the nation's economy, the Non-Banking Financial Sector (NBFCs), that was unable to tackle the challenges of unrecovered debts and NPAs even through the SARFAESI Act. Although included under the Act later, the NBFCs still find it a huge task to recover debts and deal with NPAs.

This paper briefly discusses this Act, its issue, and its efficiency, further evaluates the effects of lowering the current threshold of the SARFAESI Act for the NBFCs, and proposes some policy recommendations. The main issue that this paper focuses on is the inequality between the banking and non-banking financial sectors with respect to the ability to recover NPAs under the SARFAESI Act. While the banking sectors have been legally allowed to recover NPAs as low as ₹1 lakh, the threshold for the NBFCs is ₹20 lakh. Thus, small-level NBFCs struggle to recover debts that do not fall under this monetary threshold. Hence, this paper suggests specific reforms to the government to reduce the threshold for specified borrowings, enable a moderating body to attend to disputes, create awareness, and encourage borrowers to settle their debts on time.

II. Introduction

The banking and non-banking sectors of finance have massive significance in shaping and developing the Indian economy. They promote credit flow, grant investment loans for individuals and businesses, enhance financial inclusivity, aid in infrastructure development, and drive comprehensive economic growth. Banking sectors here generally focus on traditional financial services like giving loans, credit cards, and checking and savings accounts. Non-Banking Financial Companies (NBFCs) work in rural and semi-urban areas nourishing Small and Medium Enterprises (SMEs) and Micro, Small, and Medium Enterprises (MSMEs) by aiding them with financial assistance.

These NBFCs offer financial services such as money lending, leasing, hire-purchasing, insurance, and so on, but they are not technically "banks" with proper licensing. The main feature

[1] Business Today
[2] The Economic Times

differentiating them from banks is that an NBFC cannot accept demand deposits of its own. The NBFCs come under the Reserve Bank of India's (RBI) purview.

The NBFCs lend money to businesses or individuals, classified based on their utility as secured or unsecured. A secured loan is where the loan is provided to the borrower with an asset that is required to be put up as collateral. These assets may include land, houses, and vehicles, along with a few others. An unsecured loan is provided to the borrower without any asset as collateral, based on the borrower's promise to repay and creditworthiness. For this paper, the secured loan alone is taken into consideration. Every loan is provided with a rate of interest for the borrower to repay. The borrower is expected to pay for the loan along with the interest amount for a specified period until the loan is fully repaid.

Theoretically, this process is a simple mechanism for the NBFCs to recollect their loans. However, such is not the case. The NBFCs have, for an extended period, faced severe difficulty in recovering their loans, which in turn severely affected the country's economy. Such loans tamper the profitability of the NBFCs and affect the credit flow as well. These secured loans that are either delayed in repayment or non-repayment are termed as Non-Performing Assets (NPAs). The laws of the country concerning commerce and finance were not on par with the financial sector reforms and broadening commercial practices in the economy. The banks and other financial institutions had to rely heavily on the judicial system, the Civil Courts, and Debt Recovery Tribunals (DRTs) to bring the non-paying borrowers to justice and recover their loans. Such judicial processes were intensely long and slow, and borrowers often tended to escape and exploit loopholes in such legal processes. The banks and financial institutions had very little authority to take any action against such borrowers. The increasing number of NPAs encroached on their profitability, and their recovery rates were too low due to the inefficiency of the DRT. It was all an undue burden on the judicial system.

In light of this deepening damage to the economy, the Central Government constituted to examine the banking sector reforms and propose suggestions for the establishment and improvement of laws in those areas. Of those committees, the Narasimham Committee I and II and the Andhyarujina Committee proposed recommendations to create a new body of legislation for providing banks and other financial institutions with securitization, authority to possess the securities and to sell them without any court's intervening. Eventually, this led to the formation of the "Securitization And Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002" (SARFAESI Act). This Act empowered banks and other financial institutions to enforce security interests without the intervention of any court, thereby driving up the loan recovery process. However, NBFCs also faced difficulties in recovering their loans as they did not have any legal authority to recover them. Thus, in 2013, with the power vested in the Central Government to legally make any non-banking financial institution a "financial institution" under Section 2(m)(iv) of the SARFAESI Act, 2002, the NBFCs were brought under the Act with a specified monetary threshold. Those NBFCs with Rs. 100 crore assets or more could utilise this Act to enforce security interest on loans of a minimum of Rs 50 lakh. Later, on 24th February 2020, the Central Government reduced that threshold to enforce security interest on loans of Rs. 20 lakh as a minimum.

III. Literature Review

Latha (2023) thoroughly analyses the SARFAESI Act and its impacts on the Indian Economy and further proposes actions by the Government, such as integrating the IBC, legislative amendments, and introducing alternative dispute resolution processes.

Srinivas, Sharanraj, Chatni, and Karanth (2024) evaluate the effectiveness of Lok Adalat, DRT, IBC, and SARFAESI Act in loan recovery by performing a comparative analysis between the number of NPAs involved and the amount recovered. It is highlighted that the IBC and SARFAESI Act have been more effective as recovery mechanisms, yet more efficient recovery mechanisms are needed.

Singh and Kumar (2024) explore the impact of the SARFAESI Act on stressed assets. They compared it with DRT, IBC, and Lok Adalat and found that it is a better loan recovery mechanism than the rest for recovering NPAs for Indian banks.

Savadi (2020) critically analyses the SARFAESI Act and assesses how well judicial interpretations balance the conflict between creditors and borrowers while also enabling the creditors to enforce security interests upon NPAs.

Bhavana, Farhina and Mazhar (2019) evaluate the impact of the SARFAESI Act on the public sector banks in recovering NPAs. The efficiency of recovery tribunals and the SARFAESI Act are discussed, and the need for more effective recovery mechanisms in the banking sectors is highlighted.

IV. Research Gap

While there are a handful of papers by authors discussing the effects of the SARAFEASI Act in various banking and other financial sectors, there is very little introspection into the Non-Banking Financing Companies (NBFCs) in the Indian Economy, which play a significant role in enhancing both the formal and informal economy of the country. Additionally, the evaluation of the impact of the SARFAESI Act in enabling the NBFCs to recover their debts and deal with NPAs is discussed in passing, by such papers.

V. Objectives

- To understand the effects of utilising the SARFAESI Act by NBFCs in loan recovery processes
- To evaluate the effects of lowering the threshold of the Act on loan recovery processes for NBFCs

VI. Hypothesis

In consideration of the objectives of this study, a null hypothesis was framed, followed by an alternative hypothesis, and they are as follows:

H_0: There is no landmark difference in the recovery of NPAs by NBFCs before the SARFAESI Act

H_1: There is a landmark difference in the recovery of NPAs by NBFCs post the SARFAESI Act

VII. Methodology

The methodology used in this research is a mixed method. Primary data from annual RBI Reports are employed for interpretation. Along with this, the effects of the SARFAESI Act on NBFCs in recovering debts and the effects of reducing the existing monetary threshold on the Act for NBFCs are critically evaluated.

VIII. Limitations of the study

This research has the following limitations:

- This research focuses solely on NBFCs and their performance concerning the recovery of NPAs
- This study is based only on the limited data available concerning NBFCs, and proper statistics and primary data are unavailable.
- This study bases itself only on the limited data on existing trends and provides a speculative evaluation of future effects.

IX. SARFAESI Act, 2002

The Securisation And Reconstruction of Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) was a benchmark legislation in the Indian financial commerce sector. The Act paved a less complex and relatively short path for banks, financial institutions, and NBFCs to recover the Non-Profitable Assets (NPAs) through comparatively more straightforward processes. In 2013, the Government amended the Act to be utilised by NBFCs with an asset worth Rs. 100 crores and on secured loans not less than Rs. 50 lakh. Later, in 2020, the Central Government reduced this monetary threshold of loans for NBFCs to Rs. 20 lakh, which helped those NBFCs to recover a considerable amount of NPAs that existed then.

The Act applies only on specific conditions, and they are as follows:

- Applies without the court's intervention
- Applies only to "secured" assets
- This applies to both movable and immovable assets
- Does not apply for an amount less than 20% of the principal and interest
- This applies to outstanding loans and those that are classified as Non-Profitable Assets (NPAs)
- Excludes loans where more than 80% of the loan has been repaid and also excludes certain types of assets like agricultural land
- Right and Recourse for Borrowers: Borrowers can settle their dues before the sale of the asset and can appeal to the Debt Recovery Tribunal (DRT) if they feel aggrieved by the lender's action.

A. Process of Loan Recovery under the Act

The process of recovery from loans that are classified as NPAs is divided into three steps. They are:

1. **Securitisation:**
   When a Bank/NBFC deals with an asset that is an NPA, it sells the receivables of that asset (vehicle or a home loan) after specific legal processes such as issuing notice to the borrower, to an Asset Reconstruction Company (ARC), which settles the debt of the Bank/NBFC. Then, the ARC converts the bought receivables into market securities and sells them to Qualified Institutional Buyers (QIBs), who are majorly foreign buyers.

2. **Reconstruction:**
   The reconstruction process is where the ARC takes over and, one, discusses the business terms of the debt, or two, settles the entire debt; or three, the ARC sells a part of the asset by converting it into share capital.

3. **Enforcement of Security Interest:**
   If the borrower does not comply with any of the three options under the Reconstruction process, the ARC sells the securities (in the auction) given for the loan and gets the money.

X. Non-Banking Financial Companies

Non-Banking Financial Companies (NBFCs) are financial institutions that are not legalised as banks but perform almost similar functions as traditional banks. Now, such NBFCs have faced many difficulties in recovering the debts of their borrowers. This has significantly affected their profitability and the country's economy.

A. Loan Recovery Process

Before the SARAESI Act, the NBFCs, banks, and other financial institutions had to go to civil court to address their grievances and recover their loans. However, such a process was heavy and prolonged and damaged their profitability. So, the Narasimham Committee I & II proposed the formation of a Debt Recovery Tribunal (DRT) to address the grievances of the NBFCs, banks, and others. While this did help the Government reduce the burden that was entirely on the civil courts, it did not show any notable improvement in the recovery from NPAs. Then, the Andhyarujina committee proposed forming separate legislation to address this issue. In 2002, the Securitization and Reconstruction of Assets and Enforcement of Security Interest Act (SARFAESI Act) was passed by the Central Government.

B. Efficiency in Recovery during the Pre-SARFAESI Era

Before the enactment of the SARFAESI Act, the Lok Adalats and the Debt Recovery Tribunal (DRT) dealt with NPA cases. In a way of addressing this issue, the Central Government, in 2013, broadened the ambit of the SARFAESI Act to be used by the NBFCs as well.

Non-Performing Assets of NBFCs (% of credit exposure)		
Period	Gross NPAs	Net NPAs
March 1999	10.2	7.0
September 1999	7.7	4.4
March 2000	9.9	9.5
September 2000	10.0	6.3
March 2001	11.5	5.6
September 2001	12.0	5.8
March 2002	10.6	3.9
September 2002	9.7	4.3
March 2003	8.8	2.7
September 2003	8.2	2.9
* Excluding MBFCs, MBCs and MNBCs		

Table 1: Report on Trends and Progress of Banking in India, 2003-04, RBI[3]

[3] RBI Report, December 2004

As mentioned earlier, before the SARFAESI Act came into existence, the NBFCs witnessed an increasing number of NPAs. In Table 1 above, it can be noted that the Gross Non-Performing Assets (GNPA) and Net Non-Performing Assets (NNPA) fluctuated over the years.

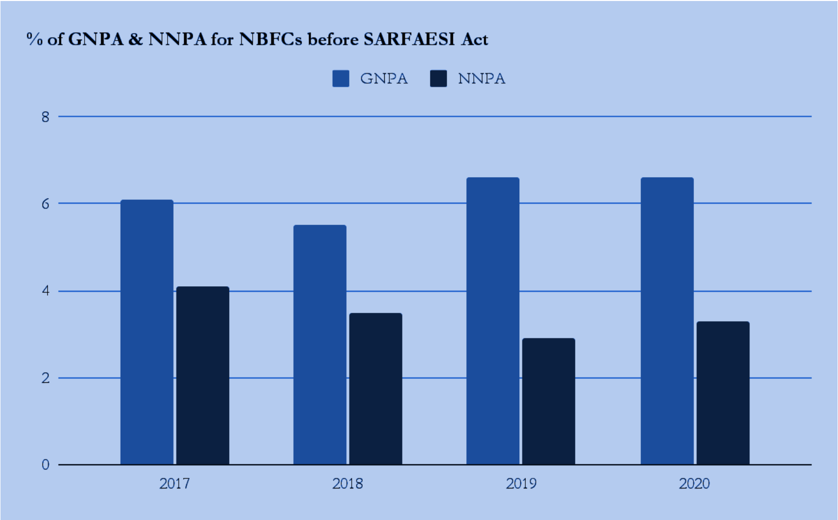

Figure 1: Report on Trend and Progress of Banking in India 2019-20, RBI[4]

From Figure 1, it is evident that before NBFCs were brought under the SARFAESI Act in 2020, the GNPA and NNPA were only growing.

C. Efficiency in Recovery during the Post-SARFAESI Era

On 24th February 2020, the Central Government included NBFCs under the SARFAESI Act, 2002 and further reduced the monetary threshold on loans from the initial Rs. 50 lakh to Rs. 20 lakh in February 2021. The effects of this move can be witnessed in the following bar graph.

[4] RBI Report, December 2020

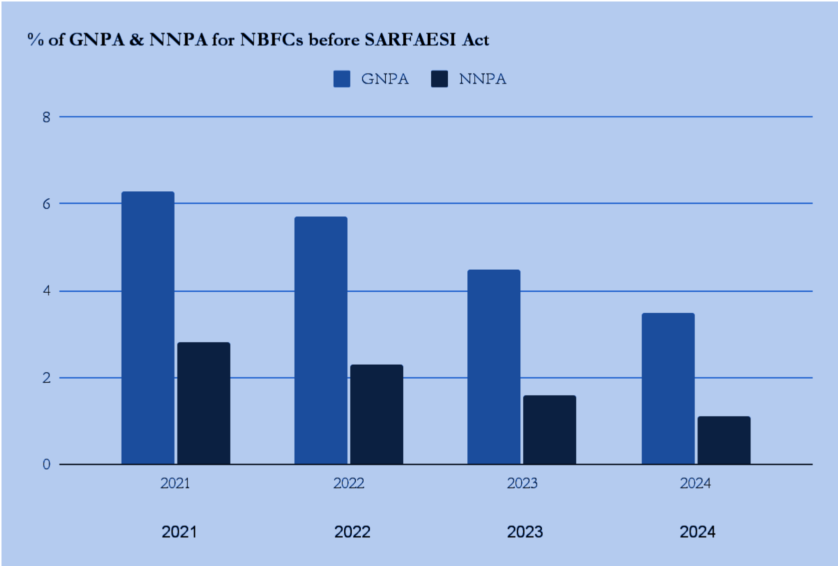

Figure 2: Report on Trends and Progress of Banking in India 2023-24, RBI[5]

From Figure 2, it can be derived that NBFCs have been able to tackle the challenges of recovering debt from NPAs by using the SARFAESI Act and have been able to reduce their GNPA and NNPA steadily since 2021.

XI. Effects of Lowering the Threshold on Loan Recovery Processes

The SARFAESI Act has widely reduced the dependency of NBFCs on the Judicial system and has enabled them to enforce security interests independently. The acknowledgement of swift actions by the NBFCs among borrowers has increased credit discipline among the borrowers. It has effectively improved the recovery rates for smaller NBFCs.

However, a transformative performance in asset quality has not yet been achieved. The NBFCs still face a challenge when dealing with NPAs below the Rs. 20 lakh mark. Unlike the NBFCs, the Government has kept the monetary threshold for banking sectors at Rs. 1 lakh, which creates an implicative inequality because while banks can take actions on NPAs as low as Rs. 1 lakh, small-level NBFCs struggle to recover debts that do not fall under its monetary threshold. Furthermore, NBFCs have been facing hurdles in administering recovery of delayed debts through the Act. Along with several other suggestions, "NBFCs also called for reducing the loan amount threshold for enforcing security interest under the SARFAESI Act to Rs 1 lakh from Rs 20 lakh."[6] Thus, this section proposes to the Government an evaluation of the effects of lowering the existing monetary threshold for NBFCs.

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[5] RBI Report, December 2024

[6] Financial Express

The effects of lowering the existing SARFAESI Act threshold on loan recovery processes for NBFCs will have the following impacts:

- The process of loan recovery for small-scale NBFCs would widely increase, thereby facilitating quicker recovery of loans and reducing their NPAs
- Consecutively, this enhances the cash flows, which grows their lending capabilities
- The reduction of NPAs will increase the creditworthiness of the NBFCs, which will, in turn, show progress in the trustworthiness between investors and lenders
- Small-scale NBFCs will be able to require their debts lower than the threshold, and this will benefit their profitability
- Borrowers will be compelled to be cautious; otherwise, the NBFCs will be able to enforce security interests on their assets legally
- Creates a healthier credit market since stress assets of the NBFCs would be decreased
- It could benefit micro, small, and medium enterprises (MSMEs) through broad lending processes if appropriately managed.

XII. Policy Recommendations

Implementing such a lowering of the threshold would be a challenging task for the Government as several individual and small-scale borrowers may be easily affected by the implications of the Act by the NBFCs under such a circumstance. Hence, this paper offers some recommendations to the Government while reducing the threshold for loan recovery processes for the NBFCs. The recommendations are as follows:

- Instead of reducing the threshold based only on the monetary aspect, the Government could implement a reduction that is specific to only a few loan categories, such as MSME loans, housing loans, and similar ones, based on the borrower's profile
- It is suggested that individual borrowers and small-scale borrowers be exempted from such a lowering since they may be very vulnerable, which should not encourage the NBFCs to take advantage of
- It is recommended that the Government establishes a Mediatory body which will mediate disputes between the borrowers and the NBFCs
- It is suggested that DRT or any financial agency of the Government invigilate the actions of the NBFCs while employing the SARFAESI Act to prevent its misuse
- It is recommended that the small-level NPAs are referred to either Lok Adalat or the DRT for consideration before employing SARFAESI
- It is suggested that proper awareness is created among borrowers and that they are well informed about the process of SARFAESI before lending
- It is suggested that borrowers are encouraged to settle their debts on time by awarding them with credit scores, which will enable the borrowers to pay their dues on time

- It is suggested that the government review the effects of lowering the threshold on a time-to-time basis so that it can understand the ground reality of the situation.

XIII. Conclusion

Lowering the threshold of the SARFAESI Act is no simple task, and the government will have to take into consideration the data and be aware of the ground reality of the economic conditions, especially that of rural and semi-urban areas, before giving the green signal. This requires thorough research and analysis on the side of the Government, and measures are to be taken on a step-by-step basis rather than enacting reforms in one sway. Indeed, with proper thought and research, such enactment of a policy would significantly aid in the healing and growth of the nation's economy and pave the way for a transparent and prosperous economic system.

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