

INTERNATIONAL JOURNAL FOR LEGAL RESEARCH AND ANALYSIS



Open Access, Refereed Journal Multi Disciplinary
Peer Reviewed Edition :

www.ijlra.com

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INTERNATIONAL JOURNAL FOR LEGAL RESEARCH & ANALYSIS
ISSN

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RECOVERY OF DEBTS DUE TO BANKS AND FINANCIAL INSTITUTIONS WITH SPECIAL EMPHASIS ON SARFAESI ACT, 2002

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Abstract

Our nation has also turned into a never-ending whirlpool of intense economic competitiveness as a result of the strengthening global economic integration and the internationalization of production. The rapid movement of money necessitates the implementation of realistic legislation to protect against its anomalies and similar issues. There was a strong need to provide help to banks and other financial institutions in recovering loans, especially those that had grown bad and were of sub-standard quality. As a result of this, these institutions were experiencing significant financial losses. Therefore, on June 21, 2002, the President issued the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 to regulate the process of securitisation and reconstruction of financial assets and the enforcement of security interest. This Ordinance subsequently became an Act, which was approved by the President on 07.12.2002.

Subsequently, the lenders initiated the process of issuing a notice of default to enterprises that were failing to meet their financial obligations, even in accordance with the ordinance. Mardia Chemicals was one of the corporations that failed to meet their financial obligations and fought against the introduction of this Act in a court of law. M/s Mardia Chemicals Ltd. appealed to the Supreme Court and the Apex Court regarding the constitutionality of this Statute in the case of Mardia Chemicals Ltd.v. The Union of India examined and analyzed most of its components and confirmed the constitutionality of the Act. However, it invalidated Section 17(2), which required borrowers to deposit 75% of the claim amount as a prerequisite for contesting the actions of lenders at the Debt Recovery Tribunal.

The Act encompasses three primary elements: securitization, asset reconstruction, and the enforcement of security interest. The purpose of the Act is to govern the operations of securitisation and asset reconstruction businesses. Securitisation is a recently introduced financial instrument in the Indian market. The act's provisions pertain to the overall approach that

securitisation businesses would employ to offer security receipts or debentures to qualified institutional buyers (QIBs). The receipts will be privately allocated to them without any public offering.

Furthermore, the implementation of security measures has been streamlined in cases when borrowers consistently fail to meet their obligations and their accounts have been categorized as non-performing assets (NPA) in the records of banks/financial institutions that have provided the financial support. This Act, being a specialized legislation, has the potential to significantly reduce the number of Non-Performing Assets (NPA). Moreover, it has the potential to change the dynamic between the borrower and the secured creditors. The Act may also aid in monitoring and controlling Non-Performing Assets (NPAs) in the future, while also introducing a new financial culture into the system.

In addition, an earnest effort was undertaken to scrutinize the SARFAESI Act, as well as the recovery laws and mechanisms, including the shortcomings of civil court, DRT, and RDDBFI Act, 1993. Furthermore, recommendations were given for enhancing the recovery process. Nevertheless, agricultural loans have been omitted from this undertaking.

Keywords: Non-Performing Assets, Banks, Financial Institutions

INTRODUCTION

The banking sector in India is crucial for the economic development of the country. The banking sector plays a crucial role in facilitating the distribution, production, consumption and exchange processes within the economic system. It enhances the circulation of capital in the economy and drives economic expansion. The efficiency of the financial system directly influences the rate at which the economy develops. Like any other business, a bank's performance is assessed by its profitability and the quality of its assets. However, Indian banking distinguishes itself from other commercial companies by incorporating social responsibilities into its operations. The banking system in India has been tasked with achieving the objectives of fair income distribution, even regional economic development, and the mitigation and eradication of private sector monopolies in commerce and industry.

The financial sector has played a crucial role in India's endeavours to achieve rapid economic development. Due to the lack of updates in our current legal framework for commercial transactions, which has not kept up with the evolving commercial practices and financial sector changes. This guarantees the gradual rate of improvement of delinquent loans and increasing

levels of non-performing assets of financial organisations and banks.

The Central Government instituted the Narasimham Committee I and II, along with the Andhyarujina Committee, to investigate and assess reforms in the banking industry. These committees were specifically tasked with assessing the necessity for legal system modifications in these sectors. The Committees have suggested new legislation to empower Financial Institutions and Banks to purchase and trade securities without judicial intervention, as part of their efforts to enhance securitization.

The SARFAESI Act was enacted on December 17, 2002, with the purpose of establishing procedures to facilitate the prompt recovery of outstanding debts by Indian lenders. The SARFAESI Act grants banks and other financial institutions the authority to conduct direct auctions of residential or commercial properties that have been used as collateral in order to recoup loans from borrowers. Prior to the implementation of this legislation, financial institutions were had to resort to litigation in order to recover the money owed to them, a procedure that was protracted and consumed a significant amount of time.

According to the SARFAESI Act, if any borrower fails to repay the loan that was provided by a bank and secured by collateral, the bank is granted extensive authority to retrieve the outstanding amount from the borrower. Upon providing a 60-day notice period, the lender has the authority to seize the pledged assets of the borrower, assume control over their administration, designate a person to oversee them, and demand payment from the borrower's debtors in relation to the asset. This recovery approach significantly reduces the time required by banks and financial institutions to resolve issues that would otherwise be prolonged owing to court involvement. A significant limitation of the Act is its lack of applicability to unsecured creditors. The Insolvency and Bankruptcy Code, 2016 addressed these and other limitations in the recovery methods. Asset Reconstruction Companies (ARCs) are utilised by banks as an alternate method to transfer troubled assets, so ensuring a more targeted and effective settlement of questionable debt.

Chapter 2 : Main Features of SARFAESI ACT

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ('the Act') seeks to streamline the procedure for recovering unpaid loans from intentional defaulters. The SARFAESI Act established the structure for the establishment of asset reconstruction companies (ARCs) that specialise in securitizing troubled assets acquired from

banks/financial institutions. It also offers the initial legal framework that acknowledges securitization, asset recovery, and reconstruction. The specific procedure outlined in the rules imposed under the requirements of the Transfer of Property Act was eliminated. The Act now includes a clause that addresses the enforcement of rights over movable property that has been hypothecated or charged to banks/financial institutions. Banks and financial institutions have the authority to seize and take direct control of these assets.

The Act provides a comprehensive legal structure for transactions involving securitization and asset reconstruction in India. The legislation encourages the establishment of asset reconstruction and securitization firms to assume control of the Non-performing Assets amassed by banks and public financial institutions. It grants lenders and securitisation/asset reconstruction businesses the authority to acquire the assets of debtors without the need for legal intervention. Banks and financial institutions (FIs) have been granted the authority to enforce their security without resorting to litigation in court, allowing them to promptly recover their loans.

This Act is intended to achieve three specific purposes, namely.

- a. Securitisation: Establishes a legal structure for the securitisation of assets.
- b. Asset Reconstruction: Involves the transfer of non-performing assets (NPAs) to an asset reconstruction firm, which will subsequently dispose of these assets and generate returns.
- c. Enforcement of security interest: The act of implementing and carrying out the rights of secured creditors (such as banks and financial institutions) to protect their interests in the event of default or non-payment.

To achieve the aforementioned goals, it is necessary to register special purpose firms, namely Securitisation firms and Reconstruction Companies, under the Companies Act and also with the Reserve Bank of India. A Registry will be established to record the transactions involving Asset Reconstruction, Securitisation, and details of security interest.

Another facet of the Act pertains to the transfer of security interest to securitization and rebuilding businesses. They are considered as lenders and obtain financial assistance by enforcing the security interest. These corporations can also function as a recovery agency with the authority to seize assets and collect the financial aid.

The secured creditor has two viable choices for enforcing the security interest in this manner. One possible course of action is for him to exercise his legal entitlement by assuming control of the secured asset and personally selling it. Another possible choice is to transfer the right to a

Securitisation Company or Reconstruction Company that is registered with the Reserve Bank of India. This transfer would allow them to handle the disposal of the secured asset and collect the outstanding payments. The secured creditor has the authority to enforce the security interest by sending a notice under Section 13(2) of the Act. This allows them to take ownership of the security assets, assume control of the borrower's business, or designate someone to administer the security. It is important to mention that a secured creditor has the ability to exercise this right if the debt is categorised as Non-performing Assets according to the rules provided by the RBI.

According to the Act, once the secured asset is sold and all the dues of the secured creditor, along with any associated costs, charges, and expenses, are accounted for, any remaining balance is given to the rightful person. If there are any remaining outstanding balances to be collected, the creditor with security can request assistance in recovering such amounts by submitting an application to the Debt Recovery Tribunal or the relevant civil court against the debtors and guarantors. Banks and financial institutions have the authority to directly assume control of security assets and transfer them to a securitization or reconstruction firm to act as their representative.

After the secured creditor has taken action as specified in sub-section (4) of section 13, the borrower or any affected party has the choice to lodge an appeal before the Debt Recovery Tribunal. Civil courts have no jurisdiction. An appeal against the order of the Debt Recovery Tribunal can be made to the Debt Recovery Appellate Tribunal (DRAT) under section 18. The borrower is ineligible to seek protection under the Sick Industrial Companies Act (SICA) if the secured creditor initiates recovery actions and if there is any outstanding reference with the Board for Industrial and Financial Reconstruction (BIFR).

The Act was passed with the aim of expediting the collection of outstanding debts. However, because to the incorporation of three distinct concepts into a single law, it is likely to encounter challenges in its implementation. Nevertheless, the judiciary will fulfil its responsibility to protect public funds when addressing issues such as the collection of outstanding debts by banks and financial institutions. The SARFAESI Act, 2002 was designed to facilitate the recovery of debts classified as Non-performing Assets by Banks/Financial Institutions, without the need for court action. This act aims to simplify and streamline the debt collection process.

The Act includes a judicial oversight by granting appellate authority to the Debt Recovery Tribunal and DRAT. In the future, legislation must address specific flaws by modifying the Act and establishing complete rules for banks and financial institutions to carry out recovery activities without any legal obstacles.

Non -Performing Assets

A non-performing asset refers to any asset, including a leased asset, that no longer generates income for a bank or financial institution. According to Investopedia, it is a situation in which a borrower has failed to make the agreed-upon interest and principal payments to the designated lender for a lengthy period of time. The non-performing asset is thus not generating any revenue for the lender in terms of both principle and interest payments. If the borrower fails to return the principal amount and interest payments within 90 days, the loan will be classified as a Non-Performing Asset. Section 2 (1) (o) (a) of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, defines a Non- Performing Asset as an asset or account of a borrower that has been categorised by a financial institution or bank as doubtful, sub-standard, or loss asset. This classification is based on the directions or guidelines issued by the relevant authority or body responsible for administering or regulating the bank or financial institution, or by the Reserve Bank in other cases."

The banks' profits are derived from the interest differential between what they receive from borrowers and what they pay to savers. On a bank's balance sheet, loans given to customers are categorised as assets. However, Non-Performing Assets pose a significant liability for banks. This is because they put the bank's profit and income at risk, making it difficult to pay interest to savers. Additionally, Non-Performing Assets cause the economic value of the loan assets to decrease.

The loans provided to consumers do not immediately become non-performing debts. For most loans, customers are given a specific period of time called a grace period. Once this grace period ends, any outstanding bills are considered late. Additionally, once a specific amount of days have passed, the loan in question is classified as a Non-Performing Loan. The duration might vary from 90 to 180 days. Banks often classify a consumer loan that is overdue for more than 180 days and a commercial loan that is overdue for more than 90 days as Non- performing Assets.

In order for an agricultural loan to be classified as a non-performing asset, it must meet the requirement that the interest and/or installment payments, as well as the principle amount, stay unpaid for two consecutive harvest seasons. However, the designated timeframe must not exceed two years, and any outstanding loan would be classified as a non-performing asset after two years.

Classification of Non- Performing Assets

- I. Standard Assets: Standard Assets refer to assets that exhibit no signs of distress and provide no greater than average risk associated with the firm. These assets are classified as performing assets.
- II. A sub-standard asset is an asset that has been classified as non-performing for a period of one year or less. Another instance in which an asset class or a loan account of the bank is categorised as a sub-standard asset is when the terms and conditions pertaining to the loan account are modified or renegotiated. Based on the satisfactory performance of the examined terms, the account must be classified as a sub-standard asset for a minimum of 12 months. Hence, just changing the conditions of the account without sufficient compliance does not lead to the improvement of the asset category.
- III. An asset is classified as a questionable asset if it has remained in the sub-standard asset category for a consecutive period of twelve months. A loan classified as doubtful shares all the inherent drawbacks of assets categorised as sub-standard, but with the added characteristic that the limitations make it highly doubtful and unlikely that it can be fully liquidated or collected based on currently known facts, circumstances, and values.
- IV. A non-performing asset is classified as a loss asset when the bank, internal or external auditors, or the RBI inspection acknowledge the loss, but the total amount has not been completely written off. In essence, this type of asset is deemed uncollectible and has so negligible value that it is not rational to view it as a viable asset, although there may be some potential for reclamation or recovery.

Importance of the Issue of Non -Performing Assets

The bank's revenue system in the economy would be weakened as the amount of non-performing assets increases. The majority of banks have the ability to handle a rise in non-performing assets in the near term because they have significant reserves or capital available to offset any losses. However, after the reserved capital has been depleted, non-performing loans would start to impede a bank's expansion.

Examining the problem of Non-performing Assets is crucial due to its detrimental effects on the return on assets. Banks will experience a decline in their interest income since it is recorded solely based on when it is received. The profitability of banks will be negatively impacted due to the

allocation of dubious loans and subsequent write-off as bad debts. Additionally, the Return on Investment (ROI) would decrease and the cost of capital or interest on loan will increase.

Non-performing assets have a detrimental impact on the economic system, causing instability and hindering its growth. An increase in the non-performing assets of banks will result in a shortage of funds in the Indian securities markets. In addition, if the banks are not confident in the repayment of the money they have lent, only a limited number of banks will be inclined to provide loans.

The presence of non-performing assets will ultimately result in significant financial losses for the banks' shareholders, as the institutions themselves will struggle to remain viable in the market. This will subsequently lead to a crisis of trust and certainty in the market. The interest rates on the loans will experience a significant hike. An increase in interest rates will have a direct impact on investors seeking financing for the establishment of projects such as infrastructure and industrial projects.

The general populace would be similarly impacted since retail consumers will now have to pay a higher interest rate for loans such as home loans and vehicle loans. This would result in a series of reduced withdrawals of cash from the security market, which will negatively impact the overall demand in the Indian economy. Ultimately, this will lead to decreased growth rates and increased inflation due to the elevated cost of capital.

Legal Mechanism to solve the Problem of Non -Performing Assets

One straightforward approach to reduce the number of non-performing assets is to successfully retrieve the defaulted debts. In an attempt to address the issue of financially struggling companies, the Government introduced The Sick Industrial Companies (Special Provisions) Act, 1985. However, instead of resolving the challenges faced by these companies, the act instead worsened the problem of Non-Performing Assets. During the period of September 1990, public sector banks filed approximately 1.5 million cases, while financial institutions had 304 cases ongoing in several courts for the purpose of debt recovery. An outstanding amount of Rs. 6,013 Crores was discovered. To address the situation, the Government established a committee led by Mr. Narsimhamand. This committee proposed the creation of Debt Recovery Tribunals, resulting in the enactment of the Recovery of Debts Due to Banks and Financial Institutions Act in 1993. The outcomes resulting from the establishment of Debt Recovery Tribunals and Appellate Tribunals under the Act can be described as somewhat promising. The Government of India is

implementing financial reforms based on the recommendations of the Narasimham Committee report I and II. In order to improve the credit monitoring process of banks and financial institutions, the Reserve Bank of India has introduced prudential requirements. In order to enhance the process of banks and financial institutions collecting outstanding debts, the Government of India enacted The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Sick Industrial Companies (Special Provisions) Act (SICA), 1985

The Sick Industrial Companies (Special Provisions) Act, 1985 introduced the definitions of a 'sick company' and a 'possible ill firm'. According to the Act, the corporation was considered sick if there was a total depletion of its net worth. According to Section 3 (1) (o) of the Act, a "sick industrial company" is defined as an industrial company that has been registered for at least five years and has accumulated losses at the end of the financial year that are equivalent to or greater than its entire net worth.

[Explanation – To eliminate any uncertainties, it is stated that an industrial company that was in existence just before the enactment of the Sick Industrial Companies (Special Provisions) Act, 1985, and has been registered for a minimum of five years, will be considered a sick industrial company if, at the end of any financial year, its accumulated losses are equal to or greater than its entire net worth.]

The SICA (Sick Industrial Companies (Special provisions) Act, 1985 established two quasi-judicial entities, namely the "Board" for Industrial and Financial Reconstruction and the "Appellate Authority" for Industrial and Financial Reconstruction. These bodies are defined under Section 3(a) and 3(b) of the Act. Section 15 of the SICA stipulated that if a firm became a financially distressed industrial company within sixty days after finalising its duly audited accounts, it could be referred to the Board for Industrial and Financial Reconstruction. The SICA was unsuccessful as a result of its antiquated methodology in addressing bankruptcy matters. The method used to identify a financially distressed unit was based on a balance sheet analysis rather than a future cash flow analysis. The erosion of net worth occurred over a considerable period of time, and the serious problems with liquidity were never resolved.

Recovery of Debts Due to Banks and Financial Institutions (RDDBI) Act, 1993

Before the implementation of the Recovery of Debts Due to Banks Act, it was customary to file

a lawsuit in a Civil Court to recover debts owed to Banks and Financial Institutions. These lawsuits were conducted and resolved following the guidelines outlined in the Civil Procedure Code of 1908. The decree issued by the Civil Courts was also implemented in compliance with the method outlined in Order XXI of the Civil method Code. The litigation process was protracted and arduous. Frequently, it required several years or even decades to fully recuperate the sum. The average duration for the resolution of a civil lawsuit, either for determining liability or obtaining a judgement, ranged from five to fifteen years. Following an extensive period dedicated to determining responsibility, significant challenges arose during the process of collecting the loan amount or selling the goods/property.

A significant proportion of banks' balance sheets contain a substantial amount of Non-Performing Assets, some of which are irrecoverable. The Non-Performing Assets were classified as Bad Debts. Retrieving these debts through the regular legal process is an arduous undertaking for banks and can take many years.

In order to address these challenges and provide Banks/Financial Institutions with an advantage over debtors, the Government enacted the "Recovery of Debts Due to Banks and Financial Institutions Act, 1993" (RDDBFI Act, 1993). The Act had amendments in 1995, 2000, 2003, and 2013. The Act was revised once again in 2016. The Act underwent a name change and was subsequently referred to as the "Recovery of Debts Due to Banks and Financial Institutions and Bankruptcy Act, 1993".

The primary objective of the Act is to establish Tribunals for prompt resolution and collection of debts owed to Banks and Financial Institutions. The primary characteristics of the Recovery of Debts Due to Banks and Financial Institutions Act 2016 are as follows:

1. The definition of property and security interest now includes Financial Leasing and Conditional Sale agreements (similar to Hire buy) as well as transactions involving intangible assets.
2. Debenture Trustees and Assets Reconstruction Companies have been included in the definition of "Financial Institutions" and "Secured Creditors".
3. The Debt Recovery Tribunal Act has been modified to encompass obligations related to debt securities and security interest.

4. File an appeal against the order of the Debt Recovery Tribunal before the Debt Recovery Appellate Tribunal (DRAT) with a requirement to deposit 50% of the amount, as opposed to the previous requirement of 75%.
5. The proposal is that the Presiding Officer of the Debt Recovery Tribunal Act should also serve as the Adjudicating Authority under the Insolvency and Bankruptcy Code, 2016.
6. The Chairperson of DRAT will also serve as the Appellate Authority under the Insolvency Code.

The Tiwari Committee, established under this Act, recommended the creation of specialised Tribunals known as the Debt Recovery Tribunals and the Debt Recovery Appellate Tribunals. These Tribunals aim to resolve the issue of recovery faced by Banks and Financial Institutions. Their main objective is to unlock a significant amount of public funds and ensure their proper utilisation for the country's development.

The requirements of this Act do not apply to Banks and Financial Institutions with outstanding amounts less than Ten lakh rupees. According to Section 2(g) of the RDDBFI Act, 1993, "Debt" is defined as any amount of money (including interest) that is claimed to be owed by a bank, financial institution, or a group of banks or financial institutions during the course of their business activities. This debt can be in the form of cash or other assets, and can be secured or unsecured. It can also be assigned to another party or be payable under a court decree, arbitration award, mortgage, or any other legally enforceable agreement at the time of the application.

Section 19(19) of the RDDBFI Act, 1993 grants the Tribunals the authority to give a certificate of recovery to the recovery officers who are specifically appointed under this Act. This certificate is issued against companies that are registered under the Companies Act, 1956. The many methods of recuperation, as regulated by Section 25 of the Act, encompass:

1. Seizure and auction of both moveable and immovable assets.
2. Detention of the accused
3. Designating a receiver to oversee the management of the defendant's properties.

Difference between SARFESI Act, 2002 and RDDBFI Act, 1993

The RDDBFI Act, 1993 empowers the Bank to seek recourse from the Tribunals in cases where the debt beyond the specified threshold. According to the RDDBFI Act, the Debt Recovery Tribunal will determine the amount owed and issue the final decision. The SARFAESI Act, 2002

establishes a process in which the Bank or Public Financial Institution will independently resolve the debt. The borrower is granted the right to appeal to the Tribunal under the SARFAESI Act, 2002 only after the Bank has made a decision. Financial institutions are only able to utilise the provisions of the SARFAESI Act, 2002 for assets that are secured, rather than for all assets. Therefore, according to the SARFAESI Act, Banks are granted authority under Section 13 to conduct the process of adjudication. The process is as outlined:

1. The Bank or Financial Institution issues a notification in accordance with Section 13 (2) to the borrower who has defaulted and whose account has been classified as "NPA".
2. The recipient of the notice under Section 13 (2) has the option to submit their objections to the Bank's claim within the specified timeframe. The Bank will evaluate the complaints, but it is not obligated to provide any decision after reviewing them. This allows the Bank to rectify any errors it may make during the adjudication process.
3. When the Bank determines that the objections are not valid, it has the authority to seize the secured asset by issuing a notification under Section 13 (4). Regarding the acquisition of property, there are two distinct actions: symbolic possession and actual possession.

The borrower is granted the opportunity to appeal to the Debt Recovery Tribunal under Section 17 and thereafter to the Debt Recovery Appeal Tribunal under Section 18, as per the provisions outlined in Section 13(4). Both the borrower and any other individual who is harmed by the Bank's actions under Section 13 of the Act have the right to seek recourse through the Tribunal, following the prescribed procedure.

The SARFAESI Act, 2002 requires a specific amount to be deposited prior to filing an appeal. The constitutionality of the SARFAESI Act, 2002 was contested in the Supreme Court. The Supreme Court has ruled that the Act is lawful, but has decreased the required deposit amount for filing an Appeal under section 17. The Bank will dispose of the secured asset if there are no legal orders from the Debt Recovery Tribunal or any competent court preventing it.

Despite its apparent simplicity, the SARFAESI Act, 2002 has faced significant criticism. The criticism is around the allegation that banks and financial firms are misusing it. Can a borrower seek recourse in the High Court to contest the actions taken by a Bank or Financial Institution under the SARFAESI Act, 2002? Is it accurate to assert that the provisions are being misused? Is the borrowers' right to safeguard against wrongdoing guaranteed?

The High Court wields exceptional authority as per Article 226 of the Constitution of India. Once

again, the courts have ruled that since the Act itself provides an alternative remedy, the High Court does not have jurisdiction under Article 226 with regards to SARFAESI cases. However, the ability to dispute the actions of Banks or Financial Institutions under the SARFAESI Act, 2002 in the High Court is contingent upon the specific facts and circumstances of the case. There is no definitive answer as to whether such recourse is possible.

While it may appear that the Act is being misused, it is not justifiable to claim that the Act oppresses the borrowers. The task at hand is a unique and delicate endeavour with a clear and commendable goal, which must be executed effectively. Due to numerous transactions and issues, Banks and Financial Institutions may make errors, prompting the Borrower to seek a stay of proceedings from the Tribunal.

APPLICABILITY OF THE SARFAESI ACT

The Act pertains to the following:-

1. Registration and regulation of Asset Reconstruction Companies (ARCs) by the Reserve Bank of India.
2. Enabling the process of securitizing financial assets held by banks and financial institutions, regardless of whether there are underlying securities involved.
3. The objective is to facilitate the smooth transfer of financial assets from banks and financial institutions to Asset Reconstruction Companies. This is achieved by allowing the acquisition of these assets through the issuing of debentures, bonds, or other securities in the form of debentures.
4. Authorising Asset Reconstruction Companies to generate cash by issuing security receipts to eligible purchasers.
5. Assisting in the restoration of financial assets obtained through the use of enforcement powers over securities or changes in management, or other powers that may be granted to banks and financial institutions.
6. Display of any securitization firm or asset reconstruction company that is officially recognised by the Reserve Bank of India as a public financial institution.
7. The term "security interest" is defined as any form of collateral, such as a mortgage or lien on real estate, provided as a guarantee for the return of financial aid provided by a bank or financial organisation.
8. The borrower's account is classified as a non-performing asset based on the recommendations or guidelines provided by the Reserve Bank of India.

9. The authorised officers will exercise the privileges of a secured creditor in this matter, in accordance with the regulations established by the Central Government.
10. A challenge to the actions of a bank or financial institution can be made to the relevant Debts Recovery Tribunal, with a subsequent appeal possible to the Appellate Debts Recovery Tribunal.
11. The Central Government has the authority to establish or facilitate the establishment of a Central Registry to register transactions related to securitization, asset reconstruction, and the development of security interest.
12. The proposed legislation will first be applied to banks and financial institutions. The Central Government will have the authority to extend the application of the Act to non-banking financial enterprises and other entities.
13. The proposed regulation does not apply to security interests in agricultural lands, loans that are less than one lakh rupees, and circumstances where the borrower has already repaid 80% of the loan.

Exemptions to the legislation

1. The SARFAESI Act does not apply to the following entities:
 - a. Regional Rural Banks;
 - b. Nationalised Banks;
 - c. Co-operative Banks;
 - d. State Bank of India and their Associate Banks.
2. This Act is not applicable in the following situations:-
 - i. A lien can be placed on any goods, money, or security given under the Indian Contract Act, the Sale of Goods Act, or any other current law.
 - ii. A pledge can be made on movable assets.
 - iii. A security interest can be created on aircraft and vessels.
 - iv. Any contract such as conditional sale, hire purchase, lease, or any other contract that does not create a security interest.
 - v. A security interest can be created to secure repayment of a financial asset, as long as it does not exceed Rs. 1,00,000/-.
 - vi. A security interest cannot be created on agricultural land.

- vii. If the amount due is less than 20% of the principal amount, it is not considered a case for security interest.
- viii. The rights of an unpaid seller and any property that cannot be attached or sold according to the Civil Procedure Code are also exempt from security interest.

Constitutional validity of SARFAESI Act 2002

Examining and understanding the constitutional vires of a statute is essential since the constitution is the highest and supreme law of the land. A law that is inherently unconstitutional cannot provide any meaningful rights or impose any legally binding responsibilities. Since no act may be constitutionally beyond the powers of the government, it is important to analyse the significant court rulings on the validity of the SARFAESI Act 2002.

1. MARDIA CHEMICALS LTD V/s UNION OF INDIA & OTHERS

[(2004) 4 SCC 311]

The Supreme Court of India, in the case of Mardia Chemicals Ltd V Union of India, made a significant ruling stating that the SARFAESI Act 2002 is legal, with the exception of subsection (2) of section 17, which is in violation of Article 14 of the Constitution of India. The decision is thoroughly examined since the purpose of enhancing the Creditors Protection Regime was legally evaluated based on the Constitution.

The Petitioner Borrower's contentions were that

- a. That the secured creditors are granted arbitrary powers.
- b. There is a lack of a suitable and sufficient method to challenge the accuracy of the demand, its legitimacy, and the exact amount of the outstanding debts that are being sought to be collected.
- c. The document does not include any provision of the Natural Justice Principle of hearing for the borrower.
- d. The RDDBFI Act 1993, which is intended for the recovery of dues, already exists.
- e. The need of a 75% pre-deposit in an appeal is arbitrary and violates Article 14.

The Respondent Banks argued that:

- a. The objective of the Act is to reduce Non-Performing Assets (NPA) in the interest of the economy.
- b. A swift law for the enforcement of security interest is crucial.

- c. The borrower has the opportunity to raise objections after receiving a notice.
- d. The requirement of a 75% pre-deposit is not mandatory and can be waived.
- e. The exclusion of civil courts' jurisdiction was necessary to avoid wasting valuable time and resources due to judicial delays.

The important factor in the decision of the Mardia Chemicals case was-

- i. Although the transaction may resemble a private contract, it is crucial to consider the significant impact it has on the country's economy as a whole. This is especially important when the financing is done through banks and financial institutions using public funds.
- ii. The outstanding debts of banking firms and financial institutions that used public funds for loans were increasing. In light of recommendations from expert groups, it was deemed necessary to establish a statute that would offer a faster solution before any significant financial setback happens. Enacting such law would serve the greater good of the public, with individual interests being secondary to it.
- iii. In cases where there is significant public interest and it is required to achieve a goal that benefits the public, individual rights may need to be compromised. The primacy of public interest over private interest has always been acknowledged.
- iv. Individual interests may be influenced to a certain degree, but they cannot surpass the importance of public interests, which have a significant impact on the socio-economic development of the country. Legislative actions implemented in the public interest have frequently infringed upon the existing rights of individuals. Although a small number of borrowers may be impacted sporadically, this would not undermine the legitimacy of the Act, which ultimately benefits the broader public interest.
- v. In today's global economy, it might be challenging to adhere to traditional methods of funding and collecting outstanding payments. Therefore, it is necessary to acknowledge that there was a need to take action to develop methods for expediting the recovery of non-performing assets (NPA's). Given the current global financial situation, if it is deemed necessary to implement a faster legal process for debt recovery, such a policy decision should not be criticised or questioned by the courts in terms of its legitimacy as a financial policy measure.
- vi. The Reserve Bank of India has established certain terms, conditions, and circumstances under which a debt is categorised as a non-performing asset. Therefore,

the claim that there are no standards for categorising the debt as a non-performing asset is unfounded.

- vii. Upon the implementation of actions specified in paragraph (4) of section 13 and prior to the property's sale or auction, the borrower has the option to submit an appeal under Section 17 of the SARFAESI Act 2002 to the Debt Recovery Tribunal. Upon receiving a 13(2) notice, if the borrower presents any objection or provides facts for the secured creditor to consider, it is necessary to carefully consider the response and provide the borrower with clear reasons for not accepting the objections, regardless of how concise they may be.
- viii. The need of a 75 percent deposit at the beginning of the proceedings appears to be excessive and unfair. The demand for a substantial deposit based only on one party's claim cannot be considered a fair condition prior to the commencement of dispute resolution. Granting the Tribunal the authority to waive or decrease the amount does not address the inherent flaw that heavily favours the party that has been solely responsible for determining the amount, establishing the default, and categorising the dues as non-performing assets, without involving or including the borrower in the process.

2. Keshavlal Khemchand and Sons Pvt. Ltd Vs. Union of India & Others [(2015) 4 SCC 770]

In this case, the borrowers raised several contentions before the Hon'ble Supreme Court of India, challenging the constitutionality of the modified definition of the phrase 'NPA' under Section 2(1)(o) of the SARFAESI Act.

- a. The Parliament relinquished its fundamental legislative role by granting authorization to other entities to establish standards that determine whether a borrower's account might be categorised as a Non-Performing Asset (NPA).
- b. The revised definition of Non-Performing Assets (NPA) allows various creditors to implement diverse guidelines that establish distinct criteria for determining whether a borrower's account qualifies as an NPA.
- c. The SARFAESI Act does not allow for a fair chance to prove that the categorization of the borrower's account as Non-Performing Asset (NPA) is unfounded. As a result, the authority to establish such a classification becomes arbitrary and in violation of Article 14 of the Constitution.

Principles evolved through judicial decisions on Constitutionality of SARFAESI Act 2002

Over time, principles regarding the constitutional legitimacy of the SARFAESI Act 2002 have developed. These principles serve as the basis for all other judicial decisions that support the rights of both creditors and debtors.

- a. Section 9 is constitutionally valid despite the absence of a show cause chance for the borrower prior to the takeover of management.
- b. The pre deposit requirement of 75% under section 18 is deemed unlawful and unjustifiable.
- c. The pre-deposit requirement of 50% under section 18 is deemed constitutionally sound, while the Debt Recovery Tribunal (DRT) has the authority to lower it to 25%.
- d. The Debt Recovery Tribunal is responsible for determining whether the actions taken by banks and financial institutions under section 13(4) comply with the provisions of the Act and the rules established under it.

The borrower has the right to make objections regarding any actions taken by the bank that may be considered illegal, such as

- a. When the adjustment of the amount is not accurately stated in the notice.
- b. The interest calculation does not adhere to the agreed terms.
- c. The bank's action is prohibited due to the statute of limitations.
- d. The bank's actions are not in line with the provisions of section 13(4). Thus, the revised section 17 is not a mere formality and is therefore constitutionally legitimate.
- e. The assignment of debt will not be deemed against public policy just because the assignee has acquired the obligation at a significantly reduced price.
- f. The borrower does not have the right to dispute the assignment of the obligation, and no court order can be made to enforce the contractual right.
- g. Section 14 of the SARFAESI Act is legally legitimate under the constitution. The absence of an adjudicatory procedure in section 14 does not automatically make Article 14 invalid. The DM/CMM is required to authenticate the presence of factual information in accordance with the affidavit provided by the secured creditor.
- h. The authority to categorise an asset as a non-performing asset (NPA) is not in violation of the constitution.

Securitization

According to Section 2(1)(z) of the SARFAESI Act, 2002, "Securitization" refers to the process of acquiring financial assets by a securitization company or reconstruction company from an originator. This can be done by raising funds from qualified institutional buyers through the issuance of security receipts that represent a share in the financial assets, or by other means. In other words, securitization means :-

- a. Securitization is a financial market innovation that involves transforming contractual debt into tangible securities, packaging and underwriting them, and then selling them to end investors.
- b. Receivables securitization is a transaction in which the owner of receivables (known as the originator or seller) sells those receivables to a third party (known as the purchaser or SPV, which stands for special purpose vehicle). In exchange, the seller receives an instant payment for the purchase price.
- c. Securitization, in its broadest meaning, refers to any procedure that transforms a financial relationship into a transaction.

Advantages of Securitization:

- (i). For banks and financial institutions:
 - a. Asset liability management refers to the strategic management of a company's assets and liabilities to ensure financial stability and minimise risk.
 - b. Reduced cost of capital and exemption from capital adequacy requirement are benefits that result in lower expenses and regulatory obligations for a company.
 - c. Enhanced liquidity
 - d. Attaining skill and specialization
 - e. Income generated from special purpose vehicle
- (ii). For individuals seeking to borrow funds or individuals looking to invest:-
 - a. Utilisation of securities for targeted risk mitigation objectives
 - b. Investment marketability and ease of converting assets into cash
 - c. Enhanced safety and increased yields
 - d. Third party surveillance

Securitization is the procedure of combining and reorganising financial assets, such as loans, into tradable securities that may be offered to investors. Securitization refers to the

conversion of illiquid assets, such as loans, into tradable securities, within the framework of poor asset management. The securitization business assumes responsibility for holding the mortgaged assets that serve as collateral for the borrower's loan. It might commence the subsequent actions:

- a. The act of obtaining financial assets from any source, such as a bank.
- b. The act of obtaining funds from qualified institutional buyers by issuing security receipts, which are used to acquire the financial assets.
- c. The act of obtaining funds in a manner that is specified by regulations.
- d. The act of acquiring a financial asset while also taking custody of the mortgaged land, building, etc.

ASSET RECONSTRUCTION

According to Section 2(1)(b) of the SARFAESI Act, 2002, "Asset Reconstruction" refers to the securitization or acquisition by a securitization company or reconstruction company of any rights or interests of a bank or financial institution in any financial assistance, with the intention of realising that financial assistance.

Asset reconstruction refers to the process of transforming a non-performing or bad asset into a performing asset. The asset reconstruction process entails multiple stages, such as the acquisition of distressed assets by a specialised Asset Reconstruction Company (ARC), which includes the underlying hypothecated asset. The bad asset is then transformed into a good asset through the utilisation of bonds, debentures, securities, and cash. Finally, returns are obtained from the hypothecated assets. The loans provided by banks are categorised as either performing or non-performing assets based on the following criteria:

1. Performing Assets

Standard assets refer to assets that are free from any issues and bear only the regular level of risk associated with the business. A performing asset is an asset that creates revenue for the bank. An asset is considered as such when neither the interest nor the principal have been late for more than 180 days (reduced to 90 days starting from March 2004) by the end of the financial year.

2. Non-performing assets

According to Section 2(1)(o) of the SARFAESI Act, a "Non-Performing Asset" refers to an asset or account of a borrower that has been classified by a bank or financial institution as sub-standard [doubtful] or lost asset. This classification is based on the directions or guidelines issued by the relevant authority or body established by law, or by the Reserve

Bank in other cases. In this study, the term "non-performing asset" refers to an asset or account of a borrower that a bank classifies based on the recommendations or guidelines of the Reserve Bank of India.

An amount is classified as a non-performing asset when it no longer generates income for the Bank. An asset can be classified as a Non-Performing Asset (NPA) if the interest and/or principal installment remain unpaid for more than 180 days (changed to 90 days starting from March 04). Banks and Financial Institutions are not allowed to include the interest earned on such Non-Performing Assets in their income unless it has been actually received or recovered. Non-performing assets are categorised into

- a. substandard assets :- It refer to loans that have been non-performing for a maximum of two years. In this case, the borrower's current net worth or the current market value of the collateral used for the loan is insufficient to guarantee full debt recovery.
- b. Doubtful Assets :- Loans that have been non-performing for more than two years and are not categorised as loss assets by the management or the internal/external auditor selected by RBI.
- c. Loss Assets :- Assets that have been identified as having incurred a loss by either the bank's internal or external auditor, or by the RBI. However, the loss amount has not been completely or partially written off. These assets are deemed irretrievable and hold minimal value for the loan institution.

OFFENCES AND PENALTIES

The Securitisation Act outlines the offence and penalties :-

- a. Failing to file details of revisions or transactions related to asset securitisation, asset reconstruction, and the creation of security interest in case of failure to file the aforesaid transaction details, both the company and its officers, as well as the lender and its officers, may be subject to a fine of up to Rs. 5,000 per day for the duration of the default.
- b. Failure to provide notification of specific contentment.
- c. Failure to comply with RBI directions by SCO and RCO. Failure to comply with the orders of the RBI will result in penalties for both the firm and its officers. The company may be fined up to Rs. 5,00,000/-, and for each day that the non-compliance persists, an additional fee of Rs. 10,000/- would be imposed.

Only a Metropolitan Magistrate or Judicial Magistrate of the First Class possesses the authority to acknowledge and adjudicate upon a crime under the Securitisation Act.

RIGHTS OF THE BORROWER

- a. The SARFAESI Act has successfully provided secured creditors with effective means to recover their long overdue debts from Non-Performing Assets. However, the rights of the borrowers have also been appropriately included in the law and cannot be disregarded.
- b. The borrowers have the option to settle their outstanding debts at any point before to the sale, thereby preventing the loss of their securities.
- c. If the Authorized Officer engages in any unlawful or unethical behaviour, he will be held accountable for legal penalties.
- d. The borrowers shall have the right to get compensation for such actions.
- e. For addressing their complaints, debtors have the option to seek recourse through the Debt Recovery Tribunal (within 45 days) and subsequently the Debt Recovery Appellate Tribunal (within 30 days) for an appeal.

The Act establishes four conditions that must be met in order for a creditor to enforce their rights.

- a. The debt is backed by collateral;
- b. The banks have categorized the debt as Non-Performing Assets;
- c. The unpaid amount exceeds one lakh and represents more than 20% of the original loan amount, including interest;
- d. The collateral to be utilized does not consist of Agricultural land.

CONCLUSION

The SARFAESI Act is enacted with a distinct purpose to facilitate banks and financial institutions to recover dues in a speedy manner by enforcement of security interest without intervention of the court. The object of the debt recovery laws is to reduce non-performing assets and increase liquidity in the market. Though the enactment of the SARFAESI Act sought to mobilise blocked funds of the banks in the non-performing assets, the various provisions of the acts have created deep sorrows for the genuine buyers. The various provisions meant to balance the requirements of the borrowers and the banks, have their balance of favour tilted towards the banks. These powers are, at majority of the times, mis-utilised by the banks to appropriate their interests against the interests of the buyers. Commendably, the Ruling has attempted to preserve the right to property of the borrower by ensuring that a borrower is not disposed without due process of law, the underlying premise being that secured creditors are not allowed to abuse the wide powers provided to them under the SARFAESI Act.

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