

## A Study on Legal Framework of Non-Performing Assets in Public Sector Banks in India

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### ABSTRACT

Non-Performing Assets (NPAs) are a recurring feature in financial crisis, poor asset quality and higher loan loss, lead to deterioration in bank's profitability and regulatory capital. Eventually NPAs can lead to bank failure, ultimately threatening the financial stability. Non-performing asset is a vital factor in the examination of the financial performance of a bank. It also shows the performance competency of the banks. NPAs provide distressing signals on sustainability and endurance capacity of the banks

The causes of NPAs are speculation, willful defaulters, fraudulent practices, internal reasons (such as inadequate technology and ineffective management, etc.) and external reasons (such as recession in the economy, infrastructural problems, etc.). India has debt recovery laws and various regulations. After the crisis in 1991 many committees and projects were formed and initiated, with recommendations for a better legal framework. The judiciary through various case decisions provides legal insights related to the legal framework of non-performing assets in public sector banks (PSBs). This paper looks into the study of legal framework and judicial decisions related to non-performing assets in public sector banks.

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Key words: Legal Framework, India, Non –Performing Assets, Public Sector Banks, Judicial Decisions, India

## 1.Introduction

Non-performing assets are a real problem for the entire banking industry all over the world. Non-performing assets (NPAs) are considered as a nightmare for the banking industry worldwide, especially for the public sector banks. The higher is the amount of NPAs, the weaker will be the bank's revenue stream.<sup>3</sup> The Indian banking sector has been facing serious problems of raising the NPAs. The non-performing asset is one of the important and dangerous concept of banking system, if the NPA is not maintained properly that get a serious effect on the profitability of the bank and also on the economy of the country.<sup>4</sup>

Sec.2 (o) of SARFAESI Act, 2001 defines non-performing asset as an asset or account of a borrower which has been classified by a bank or financial institution as substandard, doubtful or loss asset.

(a) in accordance with the instructions or guidelines pertaining to asset classifications issued by any authority or body established, constituted, or appointed by any law currently in effect in the event that such bank or financial institution is administered or regulated by such authority or body;

(b) in all other cases, in accordance with the instructions or guidelines relating to asset classifications issued by the Reserve Bank.<sup>5</sup>

S.2 (m) of SARFAESI Act, 2002 states that 'financial institution' means— a public financial institution within the meaning of section 4A of the Companies Act, 1956 which states that an institution should have been established under the instructions of any Central Act or minimum 51% of the paid up share capital of such institution must be held by the Central Government or) any organization designated by the Central Government pursuant to Recovery of Debts Due to

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<sup>3</sup>Dr.Swati Srivastava , Comparative Study of Non-Performing Assets of Public and Private Sector Banks in Uttarkhand, Volume (5), International Journal of Research and Analytical Reviews , 331 (2018)

<sup>4</sup>Dr.AartiDiwan , A Study of Non-Performing Assets (NPA):Big Barrier in Growth of Banks, Volume (6), International Journal of Research and Analytical Reviews , 671 (2019)

<sup>5</sup>Vol 1, Surrender Malik and Sudeep Malik, Supreme Court on SARFAESI/RDDB Act, Debt and Interest Recovery, EBC Publishers (2018)

Banks and Financial Institutions Act, or the International Financial Corporation, which was founded under the 1958 International Finance Corporation (Status, Immunities and Privileges) Act (42 of 1958) or under the Reserve Bank of India Act, 1934 (2 of 1934) or any other organization or non-banking financial enterprise as specified in paragraph (f) of section 45-I, which the Central Government may designate as a financial institution for the purposes of this Act by notification.<sup>6</sup>

### 1.1 Causes of NPAs

There is a cause and effect for every issue. Similarly, there many factors that cause non performing asset to be on the rise where it leads to direct effect to the economy of the country and its financial wellbeing. Some of the causes are: willful default, speculation, internal factors and external factors. Willful default is when the borrower does not repay the fund that was lent even when the borrower is capable of the repaying.<sup>7</sup> According to Central Bank, a borrower will be classified as a willful defaulter within six months after his account being classified as non-performing asset (NPA).<sup>8</sup> Speculation is the act of engaging in a financial transaction with a high potential for loss but also with the hope of making a sizable profit. Speculation also means making large income investments in riskier assets. Internal factors are those factors that affect directly are within the bank and banking industry such as inadequate technology, lack of efficient management, etc. NPAs are increasing due to a number of factors, including poor credit appraisal. The bank extends advances to those who are unable to pay them back because of bad credit evaluation, which also causes NPAs for the banks. External factors are those factors which are not in the control of banks that contribute to nonperforming assets (NPAs) include economic downturns, natural disasters, unfavorable competition, and many more. Thus, these are some of the causes of non-performing asset that affect the Indian financial economy adversely.

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<sup>6</sup>S.2 (m) of SARFAESI Act, 2002

<sup>7</sup>Master Circular on Wilful Defaulters, Reserve Bank of India, 07-01-2015, <https://www.rbi.org.in/commonperson/english/Scripts/Notification.aspx?Id=1458#21>

<sup>8</sup>Business Today Desk, <https://www.businesstoday.in/latest/economy/story/wilful-default-cases-on-the-rise-banks-filed-suits-against-36150-npa-accounts-to-recover-rs-926-lakh-cr-in-fy23-402252-2023-10-17>, (09-02-2024)

## 2. Need for laws related to NPA in public sector banks

### 2.1. Public sector

There weren't many "Public Sector" enterprises in the nation before independence. These included a few departmentally administered businesses such the Government Salt Factories, Quinine Factories, Railways, Posts and Telegraphs, Port Trusts, Ordinance Factories, and All India Radio.<sup>9</sup>

The State, which was directly in charge of industrial growth, was given priority in the 1956 Industrial Policy Resolution. As a result, the planning process (five-year plans) was started while considering the needs of the nation. Subsequently, the policy statements from 1973, 1977, 1980, and 1991 detailed the new approaches for the public sector. One could argue that 1991 marked a turning point in Indian economic liberalization. In addition to giving the economy the necessary boost, the public sector created and nourished human resources, which are essential for any business, public or private, to succeed.<sup>10</sup>

### 2.2. Public Sector Bank

Sec.2 (e) of the High Denomination Bank Notes (Demonetisation) Act, 1978, defines 'public sector bank' as bank referred to in sub-clause (ii), (iii) or (iv) of clause (a) under Sec.2<sup>11</sup>

Sec.2 (a) states that, 'bank' means--

(ii) the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955);

(iii) a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959);

(iv) a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970);<sup>12</sup>

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<sup>9</sup> Department of Public Enterprises, 'Public Sector in India: an Overview', page 1  
[https://dpe.gov.in/sites/default/files/Chapter-1-Overview%20%26%20Profile\\_Final\\_0.pdf](https://dpe.gov.in/sites/default/files/Chapter-1-Overview%20%26%20Profile_Final_0.pdf), Last visited on 09-02-2024.

<sup>10</sup>Ibid.

<sup>11</sup> Sec.2 (e) of High Denomination Bank Notes (Demonetisation) Act, 1978.

<sup>12</sup> Sec.2 (a) of High Denomination Bank Notes (Demonetisation) Act, 1978.

Prior to High Denomination Bank Notes (Demonetization) Act, 1978 there were several enactments but the public sector bank was not defined and the definition of Bank defined by the act includes the similar view of State Bank of India Act, 1955.

The nationalization of the banks is covered under the expression of the 'State' under Art 12 of the constitution.<sup>13</sup> The public sector banks are 'State' under Art 12.<sup>14</sup> The public powers and public functions discharged by the public sector bank are recognized under the express of the 'State' under Art.12 of the Indian Constitution.<sup>15</sup> The state's involvement in PSBs and the PSBs' contribution to the nation are clearly defined by the constitution.

The operations of the PSBs have been in spotlight in several instances. It has been in the highlight during the dark times as well and the operation of public sector banks (PSBs) is again in the spotlight as the economy begins to stutter toward normalcy. This is because the banking system is essential to the recovery process and government-controlled banks account for the majority of the financial sector's size and number of transactions. However, because of the significant non-performing assets (NPAs) on their balance sheets, the PSBs themselves are dealing with grave issues. The size of NPAs was expected to decrease with the implementation of policies like the Insolvency and Bankruptcy Code. However, the government and central bank responded to the pandemic and ensuing economic collapse by waiving loans, imposing repayment moratoriums, and other measures that have made matters worse.<sup>16</sup>

Neither the issue of non-performing assets (NPAs) nor the solutions proposed to address them are novel. Analysts frequently advocate for structural changes to the banking industry, with a focus on privatization, re-privatization, or lowering the government's ownership of the banks to less than 50%. These are valid points in the context of managing the financial sector. However,

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<sup>13</sup>Bank of India vs O.P.Swarnakar (2003) 2 SCC 721; Vol 1, Surender Malik and Sudeep Malik, Supreme Court on SARFAESI/RDDDB Act, Debt and Interest Recovery, EBC Publishers (2018)

<sup>14</sup>Sarsar Association v. Punjab & Sind Bank (2009) 8 SCC 257; Vol 1, Surender Malik and Sudeep Malik, Supreme Court on SARFAESI/RDDDB Act, Debt and Interest Recovery, EBC Publishers (2018)

<sup>15</sup>Karnataka state forest industries corporation v. Indian Rocks (2009) 1 SCC 150; Vol 1, Surender Malik and Sudeep Malik, Supreme Court on SARFAESI/RDDDB Act, Debt and Interest Recovery, EBC Publishers (2018)

<sup>16</sup>The India Forum, <https://www.theindiaforum.in/letters/public-sector-banks-continue-be-important>, last visited 11-02-2024

these plans often ignore PSBs' critical position in our nation's overall financial and economic structure as well as their social significance due to the level of public trust in them.

All things considered, we have a strong banking system that combines elements of the public and private sectors, reaches every region of the nation, and caters to a wide range of customers. More prudential oversight and more effective management of these institutions are required to prevent banks from engaging in "lazy banking" or "crazy banking," as well as less intervention from the established powers. More importantly, all stakeholders must improve their financial discipline and conduct. The system might be able to handle it if the money borrowed is not returned for legitimate reasons, but not if dishonest borrowers and deliberate defaulters routinely embezzle large sums of money.

### **3. Legal and regulatory framework**

The Indian banking sector is primarily regulated by Reserve Bank of India (RBI) and the Banking Regulation Act, 1949. There are three primary laws that deals with non- performing asset which are Recovery of Debts and Bankruptcy Act, 1993 (RDB Act), the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest, 2002 (SARFAESI Act), and the Insolvency and Bankruptcy Code, 2016 (IBC).

#### 3.1. The Financial Crisis in India in 1991

Although India had the primary regulatory in the banking sector the country faced the financial crisis. India's exchange rate saw a significant alteration in the middle of 1991. The beginning of this event was a decline in the rupee's value till the middle of 1991. By using up foreign reserves, the Reserve Bank of India's officials was able to slow the value decrease. However, the exchange rate was drastically depressed against major foreign currencies on July 1 and July 3, almost to the point of exhaustion. The result of the crisis highlighted the fragility of the financial industry, extended cycles, and contagion.<sup>17</sup>

The Central government constituted several committees and projects to battle the crisis to begin with Narsimham Committee 1 in 1991. In 1991, there was an exceptionally high Statutory

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<sup>17</sup> International monetary fund on India's Financial Crisis, <https://www.imf.org/external/pubs/ft/staffp/2002/03/pdf/cerra> ,last visited on 28-02-2024

Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR). As a result, government could not employ bank resources. From 38.5 percent to 25 percent and from 15 percent to 3 to 5 percent, respectively, the committee suggested cutting the SLR and CRR and reorganizing the banking sector. It was suggested by the Narasimham Committee 1 to open fewer public sector banks. The group recommended that acquisitions and mergers boost the bank's productivity. The Committee suggested that eight to ten banks be recognized nationally. The ARF Tribunal was established because of the alarming levels of bad debt and non-performing assets (NPA) in banks during the 1991 financial crisis. The committee suggested creating an Asset Reconstruction Fund (ARF) to assume the share of bank and financial institution problematic and dubious debts

The Narasimham Committee II in the year 1998 was constituted by the central government that looked into and maintenance of orderly movements of the call money rate by, if needed, resetting Repo and Reverse Repo rates under the RBI's Liquidity Adjustment Facility (LAF) and suggested an integrated system of supervision and regulation of banks, financial institutions, and non-bank finance companies (NBFC) under a Board for Financial Regulation and Supervision (BFRS) and stressed on lower bank non-performing assets (NPAs) through the establishment of Asset Reconstruction Corporations (ARC)<sup>18</sup>

### 3.2. Regulators relating to Non-Performing Assets

The three regulators that assist in the management of non-performing assets are

- a) Recovery of Debts and Bankruptcy Act, 1993 (RDB Act),
- b) the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest, 2002 (SARFAESI Act), and
- c) the Insolvency and Bankruptcy Code, 2016 (IBC).

- a) Recovery of Debts Due to Banks and Financial Institution Act, 1993

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<sup>18</sup>Indian Financial Reforms: National Priorities Amidst An International Crisis  
<https://www.iibf.org.in/documents/ptml-lecutre.pdf>,10-02-2024

Legal companies and individuals (borrowers) can obtain loan facilities from banks and financial organizations that have properly registered with the Reserve Bank of India (RBI). If the borrower defaults on the loan, in full or in part, including unpaid interest and other penalties, and/or the debt turns into a non-performing asset (NPA), banks and other financial institutions have the right to pursue collection of the debt through the relevant legal channels.<sup>19</sup>

Prior to the Recovery of Debts Due to Banks and Financial Institution Act, 1993 (RDDBFI Act) trail, banks and other financial institutions faced enormous difficulties in collecting debts from borrowers because the courts were overworked and unable to give priority to the recovery cases of the banks and other financial institutions. In 1981, the Indian government established a committee led by Mr. T. Tiwari. The committee recommended the creation of a quasi-judicial system that would be exclusive to banks and financial institutions. Through the use of a summary procedure, this system would enable the banks and financial institutions to expeditiously resolve recovery cases they file against borrowers.<sup>20</sup>

Once more in 1991, a committee led by Mr. Narasimham was constituted. This committee supported the conclusions of the Mr. T. Tiwari Committee and suggested the creation of a quasi-judicial system to facilitate the prompt recovery of debts. In accordance with this the Indian government passed the RDDBFI Act. The RDDBFI Act established quasi-judicial entities and outlined the process for the prompt recovery of debt.<sup>21</sup>

b) Securitisation And Reconstruction of Financial Assets And Enforcement Of Security Interest Act,2002

Securitisation And Reconstruction of Financial Assets And Enforcement Of Security Interest Act,2002 (SARFAESI Act) is an Act to regulate securitization and reconstruction of financial assets and enforcement of security interest and to provide for a Central database of security interests created on property rights, and for matters connected therewith or incidental thereto.<sup>22</sup>

The legal framework relating to commercial transactions has not kept pace with the changing commercial practices. This has resulted in slow pace of recovery of defaulting loans and

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<sup>19</sup> Tannan's Banking Law and Practice in India, Twenty Sixth Edition, LexisNexis, 2019, pg. 1439.

<sup>20</sup> Tannan's Banking Law and Practice in India, Twenty Sixth Edition, LexisNexis,2019, pg. 1440

<sup>21</sup> Tannan's Banking Law and Practice in India, Twenty Sixth Edition, LexisNexis,2019, pg. 1441

<sup>22</sup>Securitisatation And Reconstruction of Financial Assets And Enforcement Of Security Interest Act,2002; Vol 1, Surender Malik and Sudeep Malik, Supreme Court on SARFAESI/RDDB Act, Debt and Interest Recovery, EBC Publishers (2018)



mounting level of non-performing assets of banks and financial institutions. The recommendations from Narsimham Committee I and II and Andhyarujina Committee constituted by the Central Government for the purpose of examining banking sector have considered the need for the changes in the legal system in respect of these areas.<sup>23</sup>

The provisions of this act are applicable only for NPA loans with outstanding above one Lac Rupees. NPA loan accounts where the amount is less than 20% of the principal and interest are not eligible to be dealt with under this Act. Non-performing assets should be backed by securities charges to the bank by way of hypothecation or mortgage or assignment. Security Interest by way of Lien, pledge, hire, purchase and lease not liable for attachment.

The Act empowers the Bank:

- a) To issue demand notice to the defaulting borrower and guarantor, calling upon them to discharge their duties in full within 60 days from the date of the notice.
- b) To give notice to any person who has acquired any of the secured assets from the borrower to surrender the same to the Bank.<sup>24</sup>

Although this act empowers the bank with certain power this act also highlights various duties and responsibilities. The bank and its officer's roles in the process of sanctioning the loans and the interest of the bank while approving such loan and in what circumstance were they approved play a crucial role.

In *Eureka Forbes Ltd. v. Allahabad Bank*<sup>25</sup>, it was observed that the facts and circumstances need to show as to in what circumstances the loan was sanctioned and disbursed despite some glaring defects having been exposed in the appraisal report. Significant element of discretion is vested in the officers/ officials of the Bank while sanctioning and disbursing loans this discretion is circumscribed by the inbuilt commercial principles/restrictions as well as that such decisions should be free from arbitrariness, unreasonableness and should protect the interest of the bank in all events.<sup>26</sup>

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<sup>23</sup>Vol 1, Surender Malik and Sudeep Malik, Supreme Court on SARFAESI/RDDB Act, Debt and Interest Recovery, EBC Publishers (2018)

<sup>24</sup>Ibid.

<sup>25</sup>(2010) 6 SCC 193;

<sup>26</sup> Vol 1, Surender Malik and Sudeep Malik, Supreme Court on SARFAESI/RDDB Act, Debt and Interest Recovery, EBC Publishers (2018)

In *Tara Chand Vya v. Chairman and Disciplinary Authority*<sup>27</sup>, it was observed that the economic empowerment is a fundamental right of the weaker sections of the people ensured as a part of the social and economic justice envisaged in the Preamble of the Constitution. The banking business and services were nationalized to achieve the above objects. The Nationalized banks, therefore are the prime sources and pillar for establishment of socio-economic justice for the weaker sections. The employees and officers working in the banks are merely the trustee of the society but also bear responsibility and owe duty to the society for effectuation of socio-economic empowerment.<sup>28</sup>

c) Insolvency and bankruptcy code, 2016

Insolvency and Bankruptcy Code (IBC), 2016 a consolidated law on the subject in hand was recommended by the joint committee of parliament on April 28, 2016 and was passed by Parliament on May 5, 2016. Insolvency occurs when an individual, corporation or other organization cannot meet its financial obligations for paying debt as they are due. The reason behind such insolvency is poor cash management, increase in cash expenditure or decrease in cash flow. Bankruptcy is not exactly a phenomenon as that of insolvency but a legal outcome where in an insolvent debtor seeks relief. Insolvency and Bankruptcy code is enacted to groom the laws relating reorganization and insolvency resolution of corporate persons, partnership firm and individuals. It a new unified bankruptcy code that is an instrument for providing an organized and collective mechanisms for collective insolvency rather than debt recovery.<sup>29</sup>

#### Conclusion and suggestions

The legal framework and committees constituted by the Central Government along with judicial decisions have tried to keep up with pace of the rising NPAs in the public sector which is appreciable. The current legal framework has a scope for improvising in many aspects such as providing rules for bank and its officials' conduct to avoid such surge in NPAs. Many amendments are made and new laws are formed such as SARFAESI Act and Insolvency and

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<sup>27</sup>(1997) 4 SCC 565; (1997) 1 CLR 809;(1997)2 LLJ 26

<sup>28</sup> Vol 1, Surrender Malik and Sudeep Malik, Supreme Court on SARFAESI/RDDB Act, Debt and Interest Recovery, EBC Publishers (2018)

<sup>29</sup> Rajender Kumar on commentary on Insolvency and Bankruptcy Code, Whytes and Co. (2019)

Bankruptcy Code which is a game changer in the financial sector with respect to non-performing assets in public sector bank. But the current legal framework was not adequate which made the Government to establishing the National Asset Reconstruction Company Limited (NARCL) which plays a vital role in reducing the non-performing assets within the country and in reviving the Indian economy.