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Evaluating the impact of SARFAESI act and debt recovery mechanisms on non-performing assets in the Indian banking sector

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Abstract

The issue of Non-Performing Assets (NPAs) has been a persistent challenge for the Indian banking sector, affecting both profitability and economic stability. This study explores the various mechanisms introduced by the Indian government to recover NPAs, focusing on the performance of the Lok Adalat, SARFAESI Act, and Debt Recovery Tribunals (DRTs). The findings reveal that while Lok Adalats have shown limited success in recovering bad loans, the SARFAESI Act and DRTs have proven to be the most effective mechanisms for NPA recovery. The study highlights the initial success of the SARFAESI Act, which streamlined the recovery process by enabling banks to seize and auction defaulters' assets without court intervention. However, a slowdown in recoveries through SARFAESI since 2010-11 suggests the need for reforms to broaden its scope and enhance its effectiveness. This research underscores the importance of developing a more robust recovery framework to alleviate the NPA crisis in India, with special emphasis on improving risk management and regulatory reforms.

Keywords: Non-Performing Assets (NPAs), SARFAESI Act, Debt Recovery Tribunals (DRTs), Lok Adalat, Indian banking sector, asset recovery, bad loans.

1. Introduction

The Indian banking sector has been undergoing a significant transformation since the initiation of economic liberalization in the early 1990s. With reforms aimed at integrating the Indian economy with the global market, banks have witnessed notable changes in interest rates, regulatory frameworks, and operational efficiency ^[1]. Interest rates have declined considerably, enhancing access to credit for businesses and individuals. Moreover, the performance of banks has shown gradual improvement over time, although public sector banks continue to face more significant challenges compared to their private counterparts.

One of the most pressing issues plaguing the banking sector, particularly public sector banks, is the accumulation of Non-Performing Assets (NPAs). NPAs, defined as loans or advances where borrowers have failed to meet their repayment obligations, have long been a major impediment to financial stability in India ^[2]. The rise in NPAs, largely attributed to bad debts, political interference, poor law enforcement, corruption, and outdated laws, has placed a substantial burden on banks, hindering their ability to extend new credit and contribute to economic growth. Although the situation has shown signs of improvement, NPAs remain a considerable problem, especially for public sector banks.

To combat the growing menace of NPAs, the Reserve Bank of India (RBI) and bank regulators have introduced various measures aimed at linking the regulation of commercial banks to their level of risk and financial liability ^[3]. Among the most important legal reforms in recent years is the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, enacted in 2002. The SARFAESI Act provides banks and financial institutions with a powerful tool to enforce security interests and recover NPAs without resorting to lengthy and cumbersome court processes.

Prior to the SARFAESI Act, banks were often forced to enforce their security interests through judicial intervention, a time-consuming and inefficient process. In cases of mortgage, for example, the Transfer of Property Act allowed mortgagees to take possession of mortgaged property and sell it without court intervention, but only under specific circumstances, such as in English mortgage arrangements or in select urban areas like

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Kolkata, Chennai, and Mumbai. This left banks with limited legal recourse for recovering defaulted loans ^[4].

The SARFAESI Act was introduced to address these limitations, providing a comprehensive legal framework for securitizing and reconstructing financial assets, enforcing security interests, and facilitating the recovery of NPAs. The Act addresses three primary aspects:

- **Enforcement of Security Interest:** It allows secured creditors, such as banks and financial institutions, to enforce their security interests directly without court intervention.
- **Transfer of NPAs to Asset Reconstruction Companies (ARCs):** These companies manage and dispose of NPAs, recovering proceeds for the banks.
- **Securitization of Assets:** It provides a legal structure for securitizing bad loans, converting them into marketable securities.

Despite the introduction of the SARFAESI Act, several systemic issues continue to hamper the effective recovery of NPAs. Factors such as political interference, weak law enforcement, and the misuse of laws like the Sick Industrial Companies (Special Provisions) Act (SICA) have exacerbated the problem. Furthermore, corruption at various levels of the banking system and archaic legal procedures have made it difficult to address bad debts efficiently ^[5].

As part of ongoing reforms, the classification and recognition of NPAs have also evolved. Under the older framework, a loan was classified as non-performing if dues were not paid for 180 days. However, in March 2004, the RBI introduced stricter norms, aligning India's banking standards with international best practices. Since then, an asset is classified as an NPA if the borrower fails to repay for more than 90 days. This shift towards a '90-days overdue' norm brought greater transparency to the system and ensured that banks recognized bad loans more promptly, thereby enabling them to take quicker action for recovery.

An NPA can be classified under several categories:

- **Term Loans:** If interest and/or principal remain overdue for more than 90 days.
- **Overdrafts/Cash Credit Accounts:** If the account remains 'out of order' for more than 90 days.
- **Bills Purchased or Discounted:** If a bill remains overdue for more than 90 days.
- **Agriculture Loans:** If interest or principal remains overdue for two harvest seasons, but not exceeding two half-years.

In SARFAESI Act and regulatory reforms have provided significant tools for banks to address the NPA crisis, challenges remain. Continued efforts to improve law enforcement, strengthen risk management, and modernize banking practices will be crucial to ensuring the long-term financial stability of India's banking sector ^[6].

Manish Gupta (2017) rising non-performing assets is growing as a cancer in Indian banking sector. Almost all banks in India are affected with this death worthy disease. However, Government of India has enacted many legislatures to recover the dead amount of loan advanced by banks from time to time. Although all such laws have tried to recover the NPA's and these laws have proved successful to some extent. Still there is a need to investigate as which recovery mechanism has been more successful as compared to other tools. In this research paper, an attempt has been

made to analyze the effectiveness of major recovery mechanisms in comparison of SARFAESI Act 2002 ^[7].

2. Securitization and reconstruction of financial assets and enforcement of security interest act 2002 (SARFAESI)

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 was introduced to provide a more efficient and expedited process for recovering dues by banks and financial institutions. Unlike traditional methods that required the intervention of courts or tribunals, the SARFAESI Act allows for the enforcement of security interests without judicial proceedings, thus accelerating the recovery of Non-Performing Assets (NPAs).

The Act enables banks to secure their loans by taking possession of secured assets and either managing or auctioning them off to recover outstanding debts. This process is particularly significant in a landscape where NPAs have been a major issue for financial institutions, leading to liquidity problems and hampering economic growth. One of the core mechanisms of the Act is the creation of two special purpose vehicles ^[8].

- **Securitization Companies (SCOs):** These entities acquire and securitize financial assets, converting them into tradable securities, thereby increasing liquidity and allowing banks to recover funds more quickly.
- **Reconstruction Companies (RCOs):** These companies are responsible for purchasing bad loans (NPAs) from banks and financial institutions, managing them, and realizing their value through reconstruction or sale.

Prior to the SARFAESI Act, the recovery of NPAs was a long and cumbersome process, requiring banks to obtain a court decree before enforcing their claims on secured assets. The introduction of the SARFAESI Ordinance aimed to bypass this lengthy legal procedure, granting banks the authority to attach and seize the assets of defaulters more swiftly. The intent was to speed up the debt recovery process and restore liquidity in the banking sector.

However, the implementation of the Ordinance was met with mixed reactions from the trade and industry sectors. A key concern raised by businesses was the lack of distinction between wilful defaulters and normal business defaulters. Many business owners argued that external factors beyond their control, such as economic downturns and political interference, had contributed to their inability to repay loans. Consequently, they felt that being subjected to the stringent measures of the SARFAESI Act was unjust. Despite these concerns, the Central Government recognized the need for a robust mechanism to deal with the mounting NPAs, estimated at around ₹4 lakh crore ^[9].

Several committees recommended the introduction of legislation that would provide banks with a quicker and more effective means of recovering bad loans. The SARFAESI Act was designed to meet this need by enabling banks to attach and monetize the assets of defaulters, offering relief that the existing legal framework could not provide. Prior to this law, the lengthy recovery process was not only detrimental to public interest but also posed a threat to national growth, as NPAs constrained banks' ability to extend fresh credit for development.

The introduction of the SARFAESI Act sent a clear signal to both defaulters and borrowers. Defaulters were put on notice that banks now had the legal backing to swiftly enforce their security interests, while borrowers were encouraged to maintain their repayment schedules to avoid the harsh penalties associated with loan defaults^[10]. The Act has been seen as a necessary intervention to address the NPA crisis, but experts have emphasized that its success in the long term will depend on proper credit assessment and the implementation of robust risk management mechanisms (Karunakar, 2008).

Although the SARFAESI Act has been a game-changer in many respects, it is important to assess its effectiveness compared to other NPA recovery mechanisms, such as Lok Adalats (people's courts) and the Debt Recovery Tribunals (DRTs). While these alternative mechanisms have their merits, the SARFAESI Act stands out for its speed and efficiency, providing financial institutions with the tools they need to address bad debts in a timely manner. Further investigation into the comparative effectiveness of these recovery processes is essential to fully understand the role of the SARFAESI Act in resolving India's NPA crisis^[11].

3. Methods

This research paper utilizes the Doctrinal Method, primarily relying on secondary data to analyze the subject matter. The data sources for this paper include an array of published literature from authoritative institutions such as the Indian Bank and the Reserve Bank of India (RBI). In addition, various magazines, journals, books that provide insights into the current banking scenario, and research papers on related topics have been extensively reviewed and referenced. By leveraging these credible and diverse resources, the study aims to provide a comprehensive analysis of the subject, ensuring depth and accuracy in its findings.

4. Findings and Results

India's legal system has traditionally favored borrowers, often leading to slow and inefficient processes, especially when it comes to recovering loans. Once a bank issues a loan to a company, it faces challenges in recalling the loan or claiming the assets securing it due to the legal inefficiencies^[12]. To mitigate this, Debt Recovery Tribunals (DRTs) were established in 1993, aimed at providing banks with quicker access to justice and faster recovery of loans. However, even with DRTs, recovery remained slow, and the banking sector struggled to deal with rising Non-Performing Assets (NPAs).

In 2002, a significant advancement in empowering banks to recover loans more effectively came through the NPAs Ordinance, which was later formalized as the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act. This Act introduced several critical mechanisms to help banks combat NPAs:

- **Asset Reconstruction Companies (ARCs):** The Act allowed for the creation of ARCs, which can take NPAs off the balance sheets of banks, helping banks focus on healthier financial operations^[13].
- **Direct Asset Seizure:** The Act granted banks the authority to seize assets of defaulting borrowers without court intervention if the borrower failed to respond within 60 days of being issued a notice. This power was revolutionary in improving the speed of loan recovery efforts.

Despite these legislative measures, the issue of NPAs persists, particularly in nationalized banks. While private sector banks tend to maintain better credit standards and thus report lower NPAs, public sector banks continue to face higher levels of non-performing loans. This difference is often attributed to better risk management and credit assessment practices in private banks.

Global Comparisons: It is concerning that while many developed and developing countries have successfully reduced their NPA levels following the 2008–09 global financial crisis, India's NPA levels remain high. This discrepancy highlights the need for more stringent regulations and efficient recovery mechanisms^[14].

Challenges with DRTs: Despite the establishment of DRTs to accelerate the recovery process, cases continue to face excessive delays, undermining the original purpose of the tribunals. Banks have voiced dissatisfaction with the DRT system, citing that it often fails to ensure timely recovery of dues, thereby exacerbating the NPA crisis.

In this context, a review of critical studies on NPAs will help outline the precise contours of the problem and develop a rationale for continued research in this area. By understanding the challenges, inefficiencies, and legal structures that govern NPAs in India, the study aims to explore potential solutions and improvements for effective loan recovery.

5. Conclusion

Non-Performing Assets (NPAs) have posed a significant challenge to the Indian banking sector, affecting not just the banks but also the broader economy. The accumulation of NPAs directly impacts the profitability of banks, as funds that could be used for productive purposes remain tied up in unproductive assets. This has prompted the government to introduce several mechanisms for NPA recovery, each with varying degrees of success^[15].

One such mechanism is the Lok Adalat, which provides an alternative dispute resolution platform for settling NPAs. However, data suggests that Lok Adalats have not been particularly effective in recovering NPAs. Except for brief periods during 2006-07 and 2011-12, the percentage of the total amount recovered through Lok Adalats has rarely reached double digits. This reflects the limited impact of Lok Adalats in addressing the NPA crisis, particularly when compared to other recovery mechanisms.

In contrast, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act and Debt Recovery Tribunals (DRTs) have shown much more promise in terms of the amounts recovered from NPAs. These channels have proven to be the most effective tools for dealing with bad loans in the Indian banking system.

Initially, SARFAESI performed exceptionally well in recovering NPAs, particularly in the years following its introduction. The act allowed banks to seize assets and auction them without the need for lengthy court processes, making it a game-changer in the NPA recovery process. However, after 2010-11, the recovery process under SARFAESI began to slow down. This decline could be attributed to an over-reliance on SARFAESI, with many banks shifting their focus away from DRTs, thus reducing the overall efficiency of the recovery process.

Given the slowing performance of SARFAESI in recent years, there is a clear need to broaden the scope of the Act to ensure faster and more efficient recovery of NPAs. Strengthening the SARFAESI framework, possibly by introducing new reforms or streamlining procedures, could enhance its effectiveness in reducing the burden of NPAs on Indian banks.

Additionally, the Indian Bank, along with other public sector banks, has faced difficulties in controlling NPAs during the period under study, particularly in the early years of the last decade. This underscores the need for a more comprehensive strategy, combining legal reforms, better risk management practices, and enhanced recovery mechanisms to address the ongoing issue of NPAs in the Indian banking sector.

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