On Financial Sector Reform in Emerging Markets: Enhancing Creditors’ Rights and Securitizing Non-Performing Loans in the Indian Banking Sector—An Elephant’s Tale

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INTRODUCTION

For much of the 1980s and 1990s, policymakers around the globe strived for financial liberalization in emerging economies.¹ Financial globalization² brought in new

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2. Financial globalization is not a new concept, however, the “depth and breadth” of financial globalization that world has experienced in last three decades, and continues to experience, is “unprecedented.” Sergio L. Schumukler & Pablo Zoido-Lobatón, World Bank, Financial Globalization: Opportunities
participants, and along with these new participants, a “growing capital mobility.” Simultaneously, regulators around the globe continued their efforts to ensure the health and stability of world banking and financial systems in hopes of ensuring economic development for the third world. However, partly as a result of the financial crises that ravaged countries worldwide—developed economies

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6. E.g., U.S. savings and loans debacle, the Chilean banking crisis of the 1980s, the Argentine and Mexican crises in the mid-1980s and 1990s, as well as the Asian financial crisis in 1997, which brought worldwide turmoil.
and “emerging markets” alike—policymakers started rethinking their approach to economic development. In particular, the Asian financial crisis that affected Southeast Asia brought to the forefront weaknesses in the banking

7. The term “emerging markets” has become somewhat ubiquitous in the financial literature. What is meant by “emerging” in the “emerging markets” is, however, unclear. Some commentators argue that emerging markets are instead “re-emerging” markets. See, e.g., William N. Goetzmann & Philippe Jorion, Re-Emerging Markets, 34 J. FIN. & QUANTITATIVE ANALYSIS 1, 1-2 (1999) (“[M]arkets tend to emerge, submerge, and re-emerge through time. . . . many of today’s emerging markets are actually re-emerging markets . . . .”); Emerging Economies: Climbing Back, ECONOMIST, Jan. 21, 2006, at 69, 70 (“The growing clout of emerging economies is in fact returning them to the position they held for most of history.”). In any event, the term which was coined by the International Finance Corporation, see id., is used to define “[financial] markets in developing countries (low- and middle-income economies).” E. Han Kim & Vijay Singal, Stock Markets Openings: Experience of Emerging Economies, 73 J. BUS. 25, 28 n.7 (2000). This definition has become the basis of common usage of the term “emerging markets” across the board.


9. The Asian financial crisis, or Asian Contagion, as it is popularly called, Sebastian Edwards, Contagion (Revised Version of 1999 World Economy Lecture, University of Nottingham, Oct. 28, 1999) (2000), available at http://www.anderson.ucla.edu/faculty/sebastian.edwards/world_economy5.pdf, has been described as one of “the most serious financial crisis in a half a century,” Nicholas D. Kristof with Edward Wyatt, Who Went Under in the World’s Sea of Cash, N.Y. TIMES, Feb. 15, 1999, at A1 (quoting President William J. Clinton), and “something that has no parallel in human history,” id. (quoting David Hale, Chief Economist, Zurich Group). It primarily affected countries that had, until then, enjoyed strong economic performance. These countries, including the likes of Indonesia, Thailand, and Malaysia, along with the “Four Tigers,” see THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT / THE WORLD BANK, THE EAST ASIAN MIRACLE: ECONOMIC GROWTH AND PUBLIC POLICY, at xvi (1993) (referring to Hong Kong, the Republic of Korea, Singapore, and Taiwan, China as the “four tigers”), were often dubbed as the “miracle” economies, see, e.g., id., serving as models for fostering economic growth in emerging markets, see, e.g., Cynthia C. Lichtenstein, Dealing with Sovereign Liquidity Crises: New International Initiatives for the New World of Volatile Capital Flows To and From Emerging Markets, 29 MCGEORGE L. REV. 807, 808 (1998) (“[T]he Asian so-called “tigers” were considered exemplars of what liberalized (in terms of privatization of enterprise, removal of capital
sector of Southeast Asia and the issue of banking reform. This also changed the priorities for the policymakers as they realized that micro- and macro-economic conditions were equally important in a globally connected economy, and reforming international financial systems was essential for global economic well-being. More pertinent to the topic of this Comment, the Asian financial crisis also provided a glaring example for the Chinese and Indian economies to correct course and set into motion policy changes that could help them avert a similar disaster. Although China and

controls, not in terms of permitting access for foreign goods and services) emerging market economies could achieve of rapid economic growth.

However, the “miracle” faded with the Asian crisis, and academics and policymakers went scurrying around to explain what went wrong, see, e.g., THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT / THE WORLD BANK, RETHINKING THE EAST ASIAN MIRACLE (Joseph E. Stiglitz & Shahid Yusuf eds., 2001), partly because the Asian financial crisis threatened to bring about a total change in the direction of reforms in these previously fast liberalizing economies. It is, of course, debatable whether the economic growth experienced by these countries was a “miracle” in the first place. See, e.g., Paul Krugman, The Myth of Asia’s Miracle, FOREIGN AFF., Nov.-Dec. 1994, at 62; Michael S. Bennett, Banking Deregulation in Indonesia, 16 U. PA. J. INT’L BUS. L. 443 (1995) (arguing that changes to the regulatory framework of the Indonesian banking system since 1988 had left the banking sector in a precarious situation); see also Paul Krugman, Whatever Happened to the Asian Miracle?, FORTUNE, Aug. 18, 1997, at 26. After the fact, several commentators realized that signs of unsustainable growth were there before the crisis hit Asia, but policymakers and private interests both chose to continually ignore them. For a brief account of the crisis, see Nicholas D. Kristof, Global Contagion: A Narrative, N.Y. TIMES, Feb. 15-18, 1999, at A1 (a series of four articles providing “a narrative of the worldwide financial crisis that . . . illustrates how globalization increasingly stitches lives all over the world into a single economic quilt.”). For a brief but more scholarly account and analysis, see also John W. Head, Global Implications of the Asian Financial Crisis: Banking, Economic Integration, and Crisis Management in the New Century, 25 WM. MITCHELL L. REV. 939 (1999); Michael S. Bennett, Banking Deregulation in Indonesia: An Updated Perspective in Light of the Asian Financial Crisis, 20 U. PA. J. INT’L ECON. L. 1, 4 n.16 (1999) (citing various sources that discuss the Asian financial crisis).

10. Sáez, supra note 4 at 235; see also, Head, supra note 9.


India were spared in this crisis, there was a realization that Chinese and Indian banking sectors faced problems similar to those faced by the Southeast Asian economies during the build-up to the Asian crisis.

The problems that afflicted the Indian banking sector in particular were predominantly a result of decades of "directed credit" policies of successive Indian

13. As Mr. Jim O'Neill, Managing Director & Head of Global Economic Research, The Goldman Sachs Group, Inc., remarked upon reading an earlier draft, "why did India avoid the Asian crisis?" is an important question. Email from Jim O'Neill, Managing Director & Head of Global Economic Research, The Goldman Sachs Group, Inc., to Anshu S. K. Pasricha, Editor-in-Chief, Buffalo Law Review (Nov. 29, 2006, 04:34:00 EST) (on file with the Buffalo Law Review). I thought about it carefully before deciding that it would be beyond the scope of this Comment to try to answer that question. However, I speculate, based in part upon Mr. O'Neill's remarks, that perhaps because of the shorter time duration since the financial liberalization had started in earnest in India, by 1997 there was not enough "flighty" investment in Indian economy so as to affect it as brutally as it did Thailand and other countries. See id. ("Is it because foreign investors had not been involved, and/or there was little speculative investor focus?"). It is also possible that the Indian banking system—because regulatory reform had not yet been completed—was still under the strict foreign exchange regulatory regime, and was therefore immune to a certain extent to such exogenous shocks. See id. ("Or was it something inherently stronger about the system in India?"). See also infra note 14. It is, of course, as I concede, mere speculation, and perhaps more suited to a proper discussion in another article.

14. Sáez, supra note 4, at 243. For the purposes of this Comment, although I primarily focus on the non-performing loans in the banking sector, an experienced reader can sense that there is another set of pertinent issues always in the subtext: the issue of Asian economies' over-dependence on the banking sector in the course of economic development. Most Asian economies, especially those of China and India, enjoy a very high savings rates. Households continue to save almost a third of GDP, on an average, across Asia. These are "lent on" by the banks, and to make a logical jump, as such discussion is beyond the scope of this Comment, there is under-utilization of capital markets. To put things in perspective, the average size of bond markets in Asia remained under twenty percent of regional GDP, while that of United States is over hundred percent of GDP. Result of such reliance on the banking sector is a high-leverage financial structure which cannot absorb exogenous shocks—and perhaps even endogenous ones—efficiently, resulting in crises. This implies that among other things, a strong debt market is helpful in strengthening the economy. See also Alan Greenspan, infra note 234. For a discussion of the economic benefits of a strong debt market, see generally Günther F. Bröker, Strategies for the Development of a Viable and Efficient National Bond Market, in ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, EMERGING BOND MARKETS IN THE DYNAMIC ASIAN ECONOMIES 9, 14-17 (1993); Assad Jabre, A Strategic Priority for Emerging Markets, in INTERNATIONAL FINANCE CORPORATION, BUILDING LOCAL BOND MARKETS: AN ASIAN PERSPECTIVE 39 (Alison Harwood ed., 2000).
governments.15 During much of the second half of the twentieth century, the Indian banking sector had characteristics of social control.16 The supposed role the banking sector played in the economy was that of providing financial support for preferred sectors17 which would purportedly lead to development of the country.18 However, because of inefficient lending practices, combined with poor monitoring, perhaps even corruption,19 the Indian banking sector became saddled with huge folios of non-performing loans. In fairness to Indian policymakers, they realized the weaknesses in their banking sector before the Asian financial crisis, and had already instituted committees for understanding the problem.20 However, Asian crisis only served to increase the urgency in the Indian policy circles.

15. See infra Part I.B. As a side note, such directed credit policies were perhaps necessary in the predominantly rural economy so as to provide the small farmers with funds necessary to support their farming ventures. Therefore, I hope that I do not stir a hornet’s nest as I delve into the effects of such policies on the banking sector’s health as a matter of economics without going into the details of “need” or social merit of such policies. See also infra note 24.

16. The policy was formally announced only in 1967. See infra Part I.B, notes 61-69.

17. See infra Part I.B.

18. The financial system in India—at least in the latter half of last century—depended heavily on the development finance institutions, which provided financial assistance to large and small industrial concerns. Leading development finance institutions in India were, and continue to be, the Industrial Finance Corporation of India, Industrial Development Bank of India, and the Industrial Credit and Investment Corporation of India (now ICICI). In addition, the Small Industries Development Bank of India, SIDBI, was created in 1989 to provide “financial assistance leading to the promotion, financing, and development of small-scale projects and microenterprises.” SÁEZ, supra note 1, at 43.

19. Although discussion of the malaise that afflicted Indian banking sector during the times the economy was protected is outside the scope of this Comment, in general social control and the policy of directed lending led to the huge folios of non-performing loans. See infra Part I.B. But see supra note 15.

Over the course of the 1990s, in order to clean up its banking system, the Indian government embarked upon major regulatory reform by instituting a series of smaller steps. Most recently, among other things, the Indian government has allowed banks and financial institutions to securitize non-performing assets (NPAs).

Part I lays out the present structure of the Indian banking sector, while also providing a quick overview of the policy of “social control” leading to nationalization of some private commercial banks in India. The reason for this emphasis is that it is often argued that the era of “social control” that led to the policy of “directed credit” was one of the primary reasons for the buildup of NPAs in the Indian banking sector. Part I also explains how the problem of non-performing loans has been plaguing the Indian banking

21. See infra Part I.D.
22. See infra note 200 and accompanying text for a definition employed in the regulatory scheme in India.
23. See infra note 201, and accompanying text for a definition employed in the regulatory scheme in India.

24. I do not consider here whether this argument has merit to it or not. However, government ownership of banks has been viewed with some optimism by several scholars, most notably by Alexander Gerschenkron. See generally ALEXANDER GERSCHENKRON, ECONOMIC BACKWARDNESS IN HISTORICAL PERSPECTIVE: A BOOK OF ESSAYS (Harvard University Press 1962) (arguing that in countries like Russia, there was severe scarcity of capital, which coupled with dismal standards of honesty in business meant that only the government could fulfill the function of providing industrial credit). This school of thought thus focuses on the role of government in controlling finance, and boosting economic growth. These ideas became the hallmark of economic policy in Asia and other developing regions in 1960s and 1970s. See, e.g., Rafael La Porta et al., Government Ownership of Banks, 57 J. Fin. 265, 266 (2002); see also, infra Part I.B. However, the alternate view, the so-called political view of state banks holds that public ownership of banks provides “an effective means for politicians to influence the allocation of credit, allowing them to support firms and enterprises that may further their political interests.” P. Demetriades & S. Andrianova, Finance and Growth: What We Know and What We Need to Know 16 (U. of Leicester Working Paper, 2003), available at http://www.le.ac.uk/economics/research/RePEc/lee/leecon/dp03-15.pdf. It seems that, in India at least, post-nationalization of banks in 1969, see infra Part I.B, competitive environment was adversely affected. See V.R. Panchamukhi, Lessons From the National Experience of India in Mobilizing Domestic and External Resources for Economic Development, 8 ASIA-PACIFIC DEV. J. 69, 79 (2001), available at http://www.unescap.org/drpad/publication/journal_8_1/ PANCHAMU.PDF. The profitability of banks started declining and non-performing assets increased. See id.
sector, and details some steps that successive Indian governments have undertaken to resolve the problem. Part II explains asset securitization, first generally, and then utilizing non-performing loans as the underlying asset class. Part III examines the current Indian securitization legislation, focusing predominantly on the scheme adopted in SARFAESI,25 but also referring to the other legislative-judicial actions26 that have helped the banking sector to clean up their portfolios of non-performing loans. Part III also addresses some of the systemic problems for securitization in India that may threaten the nascent asset-backed securities market in India.

I conclude this Comment by claiming that, despite the problems that exist in the current Indian experimentation, securitization of NPAs has been a positive development for the Indian banking sector. While it has helped strengthen the banking sector by clearing up funds for more lending, it has also provided an impetus to the development of a stronger fixed income market in India which has the potential to have considerably more depth than its regional counterparts. Such a market is important for a developing economy like India’s so as to provide an alternative avenue of funding for industry.

This Comment thus argues that securitization-enabling legislation by Indian lawmakers is not just an exercise in providing a stop gap solution to the problem of non-performing loans in the Indian banking sector. As noted elsewhere in this Comment, the current response in India has shaped up over a decade,27 the result of a process that started as early as 1991 when the first Narasimham Committee28 reported its findings regarding the state of the

25. See discussion infra Part III.A.
26. See discussion infra Part III.B.
27. While exhaustion of such a long period of time may be supportive of the “elephant” moniker at first glance, it also means that the current policy response is not some panicky measure. Rather, it seems that there has been deliberation on Government of India’s part, over several different political alliances, and there is a well thought out strategy to make it easier for the banks to take control of and dispose of the collaterals pledged for loans that subsequently become non-performing.
28. See infra note 91.
Indian banking sector. Before reaching the current stage of reforms, successive Indian governments encouraged numerous reforms, albeit cautiously and therefore on a much smaller scale, before determining the best course of action to ensure the long term vitality of the Indian banking sector. Therefore, in light of this discussion, it may be argued that the current legislative response is a well thought out one and, therefore, perhaps not an elephant’s tale after all.

29. See infra Part I.D.
30. In the current geo-econo-political lexicon, while India is occasionally referred to as a “tiger,” see, e.g., Simon Long, The Tiger in Front: A Survey of India and China, ECONOMIST, Mar. 5, 2005, at 1; Claire Topal, China and India: A Tiger Overtaking a Dragon (Feb. 7, 2005), http://fletcher.tufts.edu/news/2005/02/schuerer.shtml, this portrayal is perhaps better suited in the backdrop of the “Four Tigers,” i.e., Hong Kong, the Republic of Korea, Singapore, and Taiwan, China, which grew rapidly over the latter half of the twentieth century, approaching the ranks of high income economies. See The INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT / THE WORLD BANK, THE EAST ASIAN MIRACLE: ECONOMIC GROWTH AND PUBLIC POLICY, at xvi (1993). However, other commentators have also used the phrase “four little dragons” while discussing the successful industrialization of these countries. See generally EZRA F. VOGEL, THE FOUR LITTLE DRAGONS: THE SPREAD OF INDUSTRIALIZATION IN EAST ASIA (1991); BRIAN KELLY & MARK LONDON, THE FOUR LITTLE DRAGONS (1989). These “tigers,” or “little dragons,” along with other East Asian “miracle” economies, see supra note 9, were admired for the financial liberalization and progress that they made before the East Asian financial crisis. See generally YERGIN & STANISLAW, supra note 3; The Commanding Heights: The New Rules of the Game (PBS television broadcast 2002) (transcript available at http://www.pbs.org/wgbh/commandingheights/lo/story/tr_menu_03.html).

However, when the talk is focused on China and India, the two “Asian Giants,” Wolfgang Schürer, A Geopolitical and Geo-economic Overview: On the Rise of China and India as Two Asian Giants, 29 FLETCHER F. WORLD AFF., 145, 145 (2005); NAT'L FOREIGN INTEL. BD., NIC 2000-02, GLOBAL TRENDS 2015: A DIALOGUE ABOUT THE FUTURE WITH NONGOVERNMENT EXPERTS 34 (Dec. 2000), and the “inevitable” comparisons are made, Simon Long, supra, at 3, “India is often portrayed as an elephant: big, lumbering and slow off the mark.” Id. at 4. See generally ASHUTO SH SHESHARALAYA, RISING ELEPHANT (2005). The focus of this Comment is primarily on the issue of non-performing assets in the Indian banking sector and on the steps undertaken by the Indian policymakers to resolve the problem. While I am not directly comparing Indian developments with those in the China, China did embark on certain similar reforms of the banking sector in the late 1990s. See Patrick J. Schena, Banks, Distressed Loans, and the Development of Chinese Markets for Asset-Backed Securities, 29 FLETCHER F. WORLD AFF. 35, 38 (2005); SÁEZ, supra note 1, at 85-88; see also generally NICHOLAS R. LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION (1998). Therefore, I suggest that the readers be mindful of the rivalry of the “Asian Giants” and draw their own conclusions on what is a better moniker for...
And so . . . begins an elephant’s tale.\textsuperscript{31}

I. INDIAN BANKING SECTOR

Section A provides an overview of the general scheme of regulation governing the Indian banking sector, as well as the structure of the Indian banking sector while emphasizing the evolution of the current state of public sector banking in India.\textsuperscript{32} Section B briefly outlines the Government of India’s policy of “social control,” nationalization of some of the private commercial banks in 1969 and then again in 1980, as well as the ensuing policy of “directed credit.”\textsuperscript{33} There is some evidence that this policy has led to the high percentage of NPAs in the Indian banking sector. This evidence is also briefly discussed.\textsuperscript{34} Section C outlines the NPAs problem in the Indian banking sector, and Section D details the initial steps undertaken by the Government of India up until 2002 when it introduced

India in light of my discussion of the Indian response to the problem of non-performing loans in the banking sector.

\textsuperscript{31} It is not clear where and how the above referenced vocabulary of dragons and elephants, see supra note 30, originated. If this is a result of some analyst’s imagination, who, while burning some midnight fluorescent, in moments of boredom, engaged himself by assigning fantasy-land descriptions to countries around the world, one can only wonder if he was aware of the mythical rivalry of the Dragon and the Elephant as described in the bestiary manuscripts of the medieval ages. See, e.g., THE BOOK OF BEASTS: BEING A TRANSLATION FROM A LATIN BESTIARY OF THE TWELFTH CENTURY (T. H. White ed. & trans., 1954) [hereinafter THE BOOK OF BEASTS]. According to a rather interesting description that accompanies the illustrations of the Elephant and the Dragon in bestiary, “[t]he dragon is the enemy of the elephant, and hides near paths where elephants walk so that it can catch them with its tail and kill them by suffocation. It is because of the threat of the dragon that elephants give birth in the water.” http://bestiary.ca/beasts/beast262.htm (last visited Feb. 17, 2007); see also THE BOOK OF BEASTS, supra, at 26. On bestiary, see generally, Willene B. Clark & Meradith T. McMunn, Introduction to BESTIARY AND BIRDS OF THE MIDDLE AGES: THE BESTIARY AND ITS LEGACY 1, 1–11 (Willene B. Clark & Meradith T. McMunn eds., 1989).

\textsuperscript{32} The choice of such focus is deliberate considering that only recently has the private sector started reemerging as a strong force in the Indian banking. For much of the duration of independent India, most of the banking activities were undertaken by the public sector banks. See infra Part I.A. Consequently most of the non-performing assets were also concentrated in the public sector banks in India. See infra Part I.C.

\textsuperscript{33} See infra Part I.B.

\textsuperscript{34} See infra Part I.B.
legislation to resolve the NPAs problem by securitizing them through Asset Reconstruction Companies (ARCs).  

A. The Structure of Indian Banking

The Reserve Bank of India (RBI) is the central bank of the country, regulating the operations of other banks, managing money supply, and discharging other myriad responsibilities that are usually associated with a central bank. The RBI was established on April 1, 1935, in

35. See infra Part I.D.

36. See generally Rustom S. Davar, Davar on Law and Practice of Banking 1-37 (10th ed. 1965) (providing a detailed account of Indian banking before and during the British rule); S. G. Panandikar, Banking in India (1934) (providing a detailed account of origins of Indian banking).

37. The Reserve Bank of India is responsible for implementation of the government’s monetary policy. For a general overview of the bank and its functions, see http://www.rbi.org.in/scripts/AboutusDisplay.aspx (last visited Feb. 27, 2007). It is important for the reader to bear in mind that, in India, although it is the RBI that discharges all the functions of a central bank, there is another commercial bank operating by the name of Central Bank of India. “Established in 1911, Central Bank of India was the first Indian commercial bank which was wholly owned and managed by Indians.” Central Bank of India, http://www.centralbankofindia.co.in/home/profile/ (last visited Feb. 16, 2007).

38. This is a rather simplistic summary of responsibilities borne by the central bankers in India. RBI performs a wide range of “functions to support national objectives,” Reserve Bank of India: India’s Central Bank, http://www.rbi.org.in/scripts/AboutusDisplay.aspx (last visited Feb. 18, 2007). These specific functions, although generally in sync with the work of central bankers around the world, are very much reflective of the intricacies of a developing economy such as India’s. Some of the specific tasks undertaken by the RBI are:

1. Formulating, implementing, and monitoring the monetary policy so as to maintain price stability and ensure adequate flow of credit to productive sectors.

2. Regulating and supervising financial system by prescribing the broad parameters of banking operations so as to maintain public confidence, protect depositor’s interest, and provide cost-effective banking services to the public.

3. Managing foreign exchange under the Foreign Exchange Management Act, No. 42 of 1999, so as to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

4. Issuing currency.

5. Acting as a banker to the Government of India and to all scheduled banks.
accordance with the provisions of the Reserve Bank of India Act\textsuperscript{39} for the explicit purpose of functioning as a central bank.\textsuperscript{40} There was additional legislation before India’s independence primarily aimed at regulating the functioning of banking companies and commercial banks.\textsuperscript{41} Originally privately owned, RBI was nationalized in 1948, post-independence from Britain, by the Reserve Bank (Transfer to Public Ownership) Act,\textsuperscript{42} and is now fully owned by the Government of India. However, the most important piece of legislation in the field of banking regulation also came soon after Indian independence when the Banking Companies Act of 1949 was passed.\textsuperscript{43} This piece of legislation has since become the “regulatory backbone of contemporary banking

\textit{See id.; see also Davar, supra note 36, at 510-12; The Business Guide to India 127 (Jitendra Kohli ed., 1996).}

\textsuperscript{39} The Reserve Bank of India Act, No. 2 of 1934 (as amended), available at http://indiacode.nic.in/.

\textsuperscript{40} According to the Reserve Bank of India Act, No. 2 of 1934, the purpose of the Reserve Bank was to “regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.” Preamble, Reserve Bank of India Act, No. 2 of 1934 (as amended), available at http://indiacode.nic.in/. Therefore, the Reserve Bank of India Act stipulated that “[a] bank to be called the Reserve Bank of India shall be constituted for the purposes of taking over the management of the currency from the Central Government and of carrying on the business of banking in accordance with the provisions of this Act.” The Reserve Bank of India Act, No. 2 of 1934, (as amended) §3 (1), available at http://indiacode.nic.in. On the role of the Reserve Bank of India in affecting monetary management, as well as in furthering the policy goals such as economic development (e.g., by selective credit control), see generally, A. Raman, Central Banking in India (1968); G. P. Gupta, The Reserve Bank of India and Monetary Management (1962).

\textsuperscript{41} Some of the provisions related to functioning of banking companies were contained in the Indian Companies (Amendment) Act of 1936. Further, in 1946, the British government passed the Banking Companies (Inspection Ordinance) Act of 1946 and the Banking Companies (Restriction of Branches) Act, primary purpose of which was to prevent the “indiscriminate branch expansion of commercial banks.” Sáez, supra note 1, at 39.


\textsuperscript{43} The Banking Companies Act was subsequently amended to read as the Banking Regulation Act. The Banking Regulation Act, No. 10 of 1949, available at http://indiacode.nic.in.
regulation.”44 The RBI itself has a central board of directors that governs its decision-making process.45

The complex network of institutions that comprise the Indian financial system can be grouped under three headings: commercial banking institutions, term-lending institutions, and non-banking financial institutions.46 The commercial banking institutions are further classified into Public Sector Banks (PSBs), Private Sector Banks, and Foreign Banks.47 Although increasing competition has


45. The RBI has a Central Board, composition of which is directed by the Reserve Bank of India Act, No. 2 of 1934 (as amended). Accordingly, 
[(t)he Central Board shall consist of the following Directors, namely:
(a) a Governor and not more than four Deputy Governors to be appointed by the Central Government;
(b) four Directors to be nominated by the Central Government . . . .;
(c) ten Directors to be nominated by the Central Government; and
(d) one Government official to be nominated by the Central Government.

The Reserve Bank of India Act, No. 2 of 1934 (as amended) §8(1), available at http://indiacode.nic.in/.

46. Sáez, supra note 4, at 238.

47. Id. The Reserve Bank of India publishes a list of banks that operate in the country. These are included in the Second Schedule of Reserve Bank of India Act, No. 2 of 1934 (as amended). The Scheduled Banks are further divided into subheadings of State Co-operative Banks, Urban Co-operative Banks, SBI and Associates, Nationalized Banks, Private Banks, Foreign Banks, and Gramin Banks. See The Reserve Bank of India Act, No. 2 of 1934 (as amended), Second Schedule, available at http://indiacode.nic.in/: ANNUAL ACCOUNTS OF SCHEDULED COMMERCIAL BANKS (Reserve Bank of India CD-ROM). Any bank that is not included in this Second Schedule may be included according to the criteria laid out in section 42 (6) (a) of the RBI Act. See DAVAR, supra note 36, at 507. Accordingly, RBI may direct the inclusion, in the Second Schedule, of banks that are not already included so long as such banks “carry[y] on the business of banking in India,” and:

(i) ha[ve] a paid-up capital and reserves of an aggregate value of not less than five lakhs [one lakh equals one hundred thousand] of rupees [roughly forty-four rupees equal one U.S. dollar], and

(ii) satisf[y] the Bank [RBI] that its affairs are not being conducted in a manner detrimental to the interests of its depositors, and

(iii) is a State co-operative bank or a company as defined in section 3 of the Companies Act, 1956 or an institution notified by the Central
reduced the dominance of PSBs in the Indian banking sector. PSBs still command a lion’s share of the sector. Amongst these PSBs, a significant amount of banking activity is undertaken by the State Bank of India and seven

Government in this behalf or a corporation or a company incorporated by or under any law in force in any place outside India[.] Reserve Bank of India Act, No. 2 of 1934 (as amended) §42(6)(a), available at http://indiacode.nic.in/.

Similarly, RBI also has the power to exclude any bank from the Second Schedule, criteria for which are again laid bare in section 42 (6)(b). Accordingly, the RBI may:

[D]irect the exclusion from . . . [the Second] Schedule . . . any scheduled bank . . .:

(i) the aggregate value of whose paid-up capital and reserves becomes at any time less than five lakhs [one lakh equals one hundred thousand] of rupees [roughly 50 rupees equal one U.S. dollar], or

(ii) which is, in the opinion of the [Reserve] Bank [of India,] after making an inspection under section 35 of the Banking Regulation Act, 1949, conducting its affairs to the detriment of the interests of its depositors, or

(iii) which goes into liquidation or otherwise ceases to carry on banking business:

Provided that the Bank may, on application of the scheduled bank concerned and subject to such conditions, if any, as it may impose, defer the making of a direction under sub-clause (i) or sub-clause (ii) of clause (b) for such period as the Bank considers reasonable to give the scheduled bank an opportunity of increasing the aggregate value of its paid-up capital and reserves to not less than five lakhs [one lakh equals one hundred thousand] of rupees [roughly forty-four rupees equal one U.S. dollar], or, as the case may be, of removing the defects in the conduct of its affairs.

Reserve Bank of India Act, No. 2 of 1934 (as amended) §42(6)(b), available at http://indiacode.nic.in/.

48. Since the liberalization of the Indian economy post-1991, the newer entrants in the market, i.e., foreign banks, new private banks, and even old private banks, have increased their share of the market at the expense of PSBs. See M. G. Bhide et al., Emerging Challenges in Indian Banking 17 (Stanford University Center for Research on Econ. Dev. and Pol’y Reform, Working Paper No. 103, 2001), available at http://scid.stanford.edu/pdf/credpr103.pdf.

49. Uday Bhasin, Challenges in India’s Banking Sector, GT NEWS, Oct. 18, 2005, http://www.gtnews.com/article/6141.cfm (“[P]ublic sector banks constitute the majority of the Indian banking system, be it by geographical reach or deposit and credit volumes.”); Bhide et al., supra note 48, at 16; SÁEZ, supra note 1, at 41 (”27 public sector banks account for . . . 90 percent of bank branches of all scheduled commercial banks in India.”).
associate institutions. The four largest public banks in India—State Bank of India, Canara Bank, Bank of India, and Bank of Baroda—account for over ninety percent of public banking assets. An additional important sub-set of the Indian PSBs is the group of nineteen nationalized commercial banks. The origin of these banks illustrates, in a rather elegant and spectacular fashion, the tension between public policy and private enterprise, especially in a fledgling democracy which faces the additional challenge of an undeveloped economy.

50. The State Bank of India Group was formed in 1955 upon nationalization of the Imperial Bank of India by introduction of the State Bank of India Act, No. 23 of 1955. O. P. MATHUR, PUBLIC SECTOR BANKS IN INDIA’S ECONOMY: A CASE STUDY OF THE STATE BANK 18 (1978). After India’s independence, RBI held a majority stake in eight banks. These banks were brought under the umbrella of the State Bank of India group in 1959, as subsidiaries, following the enactment of the State Bank of India (Subsidiary Banks) Act, 1959. SÁEZ, supra note 1, at 40. Of these eight subsidiary banks, two merged, and at present there are seven banks in the State Bank Group, in addition to the State Bank of India. Id. Although the State Bank of India group is considered the crown jewel of the Indian banking sector, it is not considered in the same league as other big names in international banking. See, e.g., BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 164 (2003) (“So Morgan Stanley and Goldman Sachs—two of the most prestigious names on Wall Street, investment banks with conservative lending rules—sometimes found themselves consigned to Tier 3, with the likes of the State Bank of India.”).

51. Sáez, supra note 4, at 238.

52. The Reserve Bank of India Act, No. 2 of 1934 (as amended), Second Schedule, available at http://indiacode.nic.in/.

53. See infra Part I.B.

54. The episode was definitely spectacular, as is evident from the brief account reproduced below. See infra note 71.

55. It seems that more than half a decade of democracy has not dispelled the notion that, in India, there is always a tussle between policy objectives and developmental objectives because of India being a democracy. This is not to suggest that democracy is not conducive to development—at least that is not my belief. See also infra. However, I may be in the minority in holding this view. This is because in recent times, when much comparison is being made between the “Asian Giants,” see supra note 30, it seems that it is fashionable to bemoan the constraints of democracy in order to defend the slow pace of economic growth in India as compared with China. See Carl Mortished, India Booms But — Unlike China — Democracy Dulls the Tiger’s Claws, GLOBE & MAIL (Ont., Can.), Feb. 9, 2006, at B17.

There is a lingering doubt that the Indian tiger will be roused from its 50-year sleep. India is not China; even as Sensex soars, the government reached a deal with airport workers, promising them job
B. Social Control, Bank Nationalization, and Directed Credit

During the early years after India gained independence, PSBs remained closely aligned with the development plans of the Government of India. The RBI, along with state governments and sponsoring commercial banks, set up Regional Rural Banks to develop the rural economy credit. Thus, agricultural laborers, small farmers, artisans, and other individuals contributing to the Indian development cause were provided credit and other banking facilities by these Regional Rural Banks. During these years—until 1969—private commercial banks continued to operate freely in an environment of a fairly liberal banking regulatory scheme. However, with time it came to be

security after a five-day strike created stinking rubbish heaps. Where China’s despotic gerontocrats can bulldoze teeming slums for new highways, India’s leaders must negotiate. . . . It is the price India pays for democracy.

Id.; see also Democracy’s Drawbacks, ECONOMIST, Oct. 27, 2005, at 23, 24 (“[I]t remains sadly true that the free market that has helped the tigers so much often works better in Communist China than in India—not least thanks to India’s own democratically elected Communist politicians.”); What’s to Stop India and China?, ECONOMIST, Oct. 27, 2005, http://www.economist.com/printfriendly.cfm?story_id=5084621 (“China is ‘more focused than India, as a democracy, can afford to be.’” (quoting India’s Prime Minister Dr. Manmohan Singh)). Contra Interview by Alex Tribeli with Simon Long, South Asia Bureau Chief of the Economist, ECONOMIST (Mar. 3, 2005), available at http://www.economist.com/audio/displaystory.cfm?story_id=3713784 (on file with the Buffalo Law Review) (“There are far more checks and balances in the Indian system than in the Chinese system. . . . There is no doubt that in looking at India one has to ask the question whether that democracy, that freedom of expression, acts as a constraint on growth, and my conclusion is no, not necessarily.”).

56. Indian independence from British rule, coming only on August 15, 1947, was accompanied by a plethora of problems for the economy of India, which was primarily agrarian, with a fledgling industrial sector. One such problem was that of ensuring adequate credit extension to sectors such as agriculture and small industries. See SÁEZ, supra note 1, at 40.

57. Id.
58. Id.
59. Id.
60. Id.
61. For example, there existed no controls on interest rates, and the reserve requirements were low. See Panicos O. Demetriades & Kul B. Luintel,
commonly perceived\textsuperscript{62} that these private commercial banks were ignoring the agriculture and small industries sector,\textsuperscript{63} and further, that they were engaging in an otherwise "corrupt" enterprise\textsuperscript{64} bordering on outright illegal conduct. In order to correct this "perceived imbalance in the lending practices of private banks,"\textsuperscript{65} the Government of India decided on a policy of "social control" on the banking sector on December 22, 1967 and later incorporated it into law.\textsuperscript{66}

Although the Government of India had high hopes from the scheme of social control, the policy did not work as well as the government had anticipated. This was partly because the scheme related only generally "to the constitution of board of directors, appointment of [bank’s] chairman, appointment of auditors[,] and take-over of defaulting banks by the government."\textsuperscript{67} Thus, the policy did not fulfill the objectives that the government had in mind, and misuse of bank credit continued unabated under the scheme.\textsuperscript{68} Because of this, the search for a new solution started in earnest. Although the charges that were levied against the


\textsuperscript{62} Whether this perception was reality is not clear.

\textsuperscript{63} SÁEZ, supra note 1, at 40.

\textsuperscript{64} M OHAMMAD QUDDUS, CONTROL OF COMMERCIAL BANKS IN INDIA 131 (1976). In a memorandum to the Government of India by the Indian Banks’ Association, following charges were leveled against the private banking sector:

(i) Banks have helped the concentration of economic power and creation of industrial or business monopolies;

(ii) the resources of banks are being misused for the benefit of directors and their concerns;

(iii) bank credit is not being distributed in the national interest or in accordance with development priorities and is not available for financing agriculturists, small borrowers or new entrepreneurs; and

(iv) bank finance is used to support anti-social or undesirable activities like hoarding or speculation.

Id. \& n.1 (citing Memorandum to Government by Mr. Krishnaraj-M.D. Thakersey, Chairman of Indian Banks’ Association, ECON. TIMES (Bombay), July 12, 1967, at 1.).

\textsuperscript{65} SÁEZ, supra note 1, at 40.

\textsuperscript{66} See infra note 71.

\textsuperscript{67} QUDDUS, supra note 64, at 133.

\textsuperscript{68} For an analysis of why the scheme failed, see id. at 136-37.
private commercial banks before imposing social control essentially related to “distribution of credit,” and the RBI was adequately empowered under the existing law to correct this imbalance, the Government of India instead chose to nationalize fourteen private commercial banks in 1969. While doing so, the Government of India made it

69. QUDDUS, supra note 64, at 132.

70. The Banking Regulation Act, No. 10 of 1949, available at http://indiacode.nic.in, stipulated that RBI could determine policy “in relation to advances[,] to be followed by banking companies generally or by any banking company in particular, and when the policy [had] been so determined, all banking companies or the banking company concerned . . . [were] bound to follow the policy as so determined.” § 21(1). The Banking Regulation Act also bestowed unlimited powers upon the RBI to “formulate credit policy for the guidance of banks. . . . [and to] give directions to banks with regard to matters like purposes, margins, ceiling limits and rates of interest.” QUDDUS, supra note 64, at 132. Finally, section 35A and section 36(1)(a) provided additional powers to the RBI to act in the way in which it deems fit “in the interest of banking as well as that of depositors and the public in general.” Id. But see id. at 133 (arguing that RBI’s lack of action was not without merit).

71. This process, as I noted before, see supra Part I.A, was rather spectacular. Although the legal machinations of nationalization started on July 19, 1969, the ground work for this move was laid in 1967 at the All India Congress Committee (AICC) session. See QUDDUS, supra note 64, at 131. This session is the annual conference for the political party Congress which remained in power through the majority of the early years of Indian independence. The Government of India devised a scheme for social control “aimed at introducing structural, organisational, operational and administrative changes in the banking system . . . [so as] to make banks serve wider national and social objectives.” Id. Thus “Social Control” was imposed on December 22, 1967, id. at 134, and was incorporated into law by the Banking Regulation Act in 1968. Id. at 133. For a discussion of the scheme of social control, see id. at 131-37. However, the policy failed to correct the perceived imbalances in bank lending to various sectors. So on July 19, 1969, the Government of India promulgated the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, No. 8 of 1969, to nationalize certain large banks. GAE, supra note 44, at 1. The Ordinance was challenged in the Supreme Court of India. However, on August 9, 1969, before a judgment could be rendered as to the Ordinance’s constitutionality, the Parliament replaced it with the Banking Companies (Acquisition and Transfer of Undertakings) Act, No. 22 of 1969. Id. This Act, although different in some respects, incorporated the same general scheme of the Ordinance. The nationalization saga continued on for several months “arous[ing] great public interest and enthusiasm.” Id. at ix. The Act was, however, subsequently held void—in its entirety—by the Supreme Court of India on February 10, 1970. See R.C. Cooper v. Union of India, A.I.R. 1970 S.C. 564. The response from the Government of India was swift, coming on February 14, 1970, in the form of the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, No. 3 of 1970. GAE, supra note 44, at 171. This Ordinance was subsequently replaced by the
adequately clear that the role of banking in an economy such as India’s must be “inspired by a larger social purpose” and must “subserve national priorities and objectives such as rapid growth in agriculture, small industry, and exports.” In 1980, another six banks were nationalized, bringing the total to nineteen nationalized banks as included in the Second Schedule today. For the next three decades, successive Indian governments pursued the policy of “directed credit.”

C. Build-up of NPAs in the Indian Banking Sector

After nationalization, banks were provided specific mandates:

(a) Banks should expand their branch network to the different parts of the country to cover rural areas and other remote areas which do not normally have access to institutionalized facilities for resource mobilization and resource supplies;
(b) banks [must] lend a stipulated proportion of their total advances to selected pre-specified sectors like agriculture, small industries, rural development, social sectors, housing, and backward regions and sections of society. This stipulation included the provision of credit for special social security schemes, like the Prime Minister’s Rozgar Yogana (PMRY) and Jawahar Rozgar Yogana; and
(c) banks were required to conform to the interest rates fixed by the Reserve Bank of India as part of the overall monetary policy of the Government. They were also required to adhere strictly to various prudential norms such as cash reserve ratio and statutory

Banking Companies (Acquisition and Transfer of Undertakings) Act, No. 5 of 1970, on March 31st, 1970, and was given effect retroactively from July 19, 1969, the date of promulgation of the original Banking Companies (Acquisition and Transfer of Undertakings) Ordinance. Id. at 171. This cleared the clouds that hovered over the nationalization of private commercial banks. For a detailed discussion and commentary on this episode, see generally, L. M. SINGHVI, BANK NATIONALIZATION AND THE SUPREME COURT JUDGMENT (1971).


73. SÁEZ, supra note 1, at 40.

74. Directed Credit is a term used to define the situation where “[l]ending decisions are taken out of the realm of profit maximisation or economic concerns and placed into the realm of politics.” Mark Miller, Political Economy of Directed Credit, http://www.ccsindia.org/policy/money/studies/wp0030.pdf.
liquidity ratio, and invest in government securities as prescribed from time to time.\textsuperscript{75}

Of particular importance among these specific mandates is banks’ obligation to lend to various specified sectors. Therefore, banks “had to honor certain obligations in terms of lending to priority sectors of the economy, such as agriculture, small industry and backward regions and classes,”\textsuperscript{76} This led to an unprecedented increase in the share of priority sector lending,\textsuperscript{77} and had some positive impact on economic development.\textsuperscript{78} However, because the Government of India was creating “artificial distortions in the market for loanable funds,” this led to inefficient investments, and by 1995, fifty percent of non-performing loans were invested in the priority sectors.\textsuperscript{79} Thus, the

\textsuperscript{75} Panchamukhi, supra note 24, at 75-76.

\textsuperscript{76} Id. at 78.

\textsuperscript{77} There were specified targets for advances to priority sectors at a minimum of forty percent of net outstanding credit. There was also a sub-target of eighteen percent for agriculture. A. Seshan, Back to Directed Credit, HINDU BUSINESS LINE, Sept. 14, 2004, available at http://www.thehindubusinessline.com/2004/09/14/stories/2004091400020800.htm.


\textsuperscript{79} Miller, supra note 74, at 99. But see Diana Farrell & Susan Lund, Reforming India’s Financial System, McKinsey Q., 2005 SPECIAL EDITION: FULFILLING INDIA’S PROMISE, at 103 (“Of the loans to the priority sectors, 23 percent, far higher that the level elsewhere in the economy, end up as nonperforming—evidence that the scale of this lending makes little sense.”). The McKinsey data is from around 2002, during which year some of the reforms that are mentioned elsewhere in this Comment had already started to take effect.
Indian banking sector, specifically the PSBs, became saddled with huge folios of NPAs.80, 81

It is difficult to put an authoritative estimate on the amount of NPAs in the Indian PSBs.82 The major cause of non-availability of these figures is not just the reluctance of official sources to come forth with actual numbers, but also because creative accounting makes it possible for the managers to conceal the real picture regarding the banks’ actual burden of NPAs.83 This practice, involving the shifting of bank loans from high-quality borrowers to low-

80. The term non-performing assets is used interchangeably with the term non-performing loans in this Comment. Non-performing assets are measured on either gross basis or on net basis (net of provisions). While the number “gross NPAs” reflects the quality of loans made by the banks, the number “net NPAs” shows the actual burden of the banks. For a discussion of different, commonly-used NPA ratios, see Paramita Mukherjee, Dealing with NPAs: Lessons from International Experiences, ICRA BULLETIN: MONEY & FINANCE 64, 67 (Jan.–Mar. 2003); see also Indira Rajaraman et al., NPA Variations Across Indian Commercial Banks: Some Findings, 1999 ECON. & POL. WKLY. 161, 168 n.3 (describing how gross NPAs can be converted to net NPAs).

81. Figures available from the Reserve Bank of India indicate that PSBs have higher levels of non-performing loans than their private counterparts. See ANNUAL ACCOUNTS OF SCHEDULED COMMERCIAL BANKS (Reserve Bank of India CD-ROM). As noted earlier, this was partly a result of the policy of preferential lending / directed lending to particular sectors of the economy under specific guidance from the Reserve Bank of India, so as to further the policy objectives of the Government of India, and partly due to the “inadequacies in the credit recovery processes arising from the insufficient legal provisions on foreclosure and bankruptcy and long drawn out procedures.” Akella Suryanarayana & Anuradha Sivaramakrishnan, The Indian Securitisation Act: Has the Magic Wand Finally Arrived, ICFAI READER (Sep. 2003), available at http://www.gtnews.com/article/5210.cfm (last visited Dec. 2, 2005).

82. See, e.g., Narayanan Vaghul, India’s Economic Reforms: Positive Developments, Underlying Concerns and the Big Picture (Center for the Advanced Study of India, Occasional Paper No. 10, Nov. 1999), available at http://www.ciaonet.org/wps/van01/index.html. This is because official estimates available from the Reserve Bank of India have been received with skepticism. See Banerjee et al., supra note 72, at 315.

83. In extreme cases, these creative techniques may be outright illegal. For instance, in early 1992, soon after Indian economic reforms began in earnest, certain irregularities were uncovered in the portfolio management activities of a number of commercial banks. There was an apparent “large-scale breakdown in the internal controls of banks, as well as systemic violation of Reserve Bank instructions.” Percy S. Mistry, Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda, in INDIA: THE FUTURE OF ECONOMIC REFORM 167, 205 n.7 (Robert Cassen & Vijay Joshi eds., 1995). The extent of new losses that emerged from this discovery were to the tune of Rs. 40-50 Billion. See id.
quality borrowers, is called “evergreening,” and can make it appear as if NPAs of a bank are decreasing over a period of time. In addition, the classification norms in India for mapping loan repayment delay to NPAs does not compare favorably with international norms. However, even though the estimated value of NPAs in the Indian PSBs remained highly speculative, there is general consensus that these have, historically, far exceeded the global norm of about five percent of total assets.


85. How “ever-greening” can be used to create what is tantamount to a financial smoke screen—an illusion about the true extent of a bank’s health—is readily explained by this example:

Technically, evergreening refers to the practice of ‘managing’ the balance sheet through novel ways. For instance, by inflating their advance portfolio through window-dressing, the banks can bring down their gross non-performing assets in percentage terms. This is simple arithmetic. A Rs 5-crore (Rs 50 million) NPA on an advance base of Rs 100 crore (Rs 1 billion) translates into a 5 per cent NPA level. But when the advance portfolio goes up to Rs 120 crore (Rs 1.20 billion) at the end of the year, the NPA level automatically drops to 4.16 per cent—even though no bad assets are recovered.


86. See Banerjee et al., supra note 72, at 315. There has since been gradual change in the classification norms used by the Reserve Bank of India for non-performing assets. See discussion infra Part III.A.

87. As late as year 2000–2001, some estimates pegged the value of NPAs in the Indian PSBs at about 64,000 crores [Rs. 640 Billion]. See Non Performing Assets in Banking Sector, www.indiainfoline.com/bisc/ari/perf.pdf (last visited Dec. 2, 2005). This translates to gross NPAs of about sixteen percent of total assets. See Suryanaranyana & Sivaramakrishnan, supra note 81 (“One of the most thorny issues for the Indian banking sector has been non-performing assets. According to an estimate, nationalized banks and financial institutions had sticky assets of Rs. 75,000 crore at the end of the [2002–2003] financial year. Nationalised banks alone have bad loans that account for 15 percent of their advances in gross terms and net NPAs at 7-8 percent amounting to nearly Rs. 60,000 crore.”). While the authority of these numbers may also be in doubt, see, e.g., Recommendations of Tarapore Committee on Capital Account Convertibility, http://iic.nic.in/iic3_j.htm (1997) (“Gross NPAs of the public sector banking system needs to be brought down from the present 13.7% . . . .”), what is not doubtful is that there were large amounts of NPAs on bank balance sheets, and this number has come down since the various reform measures taken by the Government of India. See infra note 232.
D. The Initial Wave of Banking Reforms

There is a consensus among policy makers that in order to tackle the problem of NPAs, two broad categories of policy reforms are usually required. One set of reforms must target the problem of existing NPAs, and another set of reforms must ensure that generation of fresh NPAs is minimized.88 This Comment focuses on progress in India to find a possible solution to the problem of existing NPAs by shifting the associated risk to willing investors in capital markets. Towards achieving this goal, at the very least, an appropriate legal and institutional environment is generally required so that there can be quick and efficient recovery of debts.89 Of course, in order to embark upon any such set of reforms, acknowledging that a problem exists is essential. As economic reform took a position at the top of the agenda for the Government of India in the early 1990s, Indian policymakers realized that banking sector reforms were necessary and that it was important to get rid of the NPAs so that banks could compete effectively in an opening Indian economy.90

The first step toward a solution to the problem of NPAs was taken when the RBI commissioned the Narasimham Committee of 1991.91 The Narasimham Committee 1991 Report pointed out that laxity of prudential norms relating to income recognition, asset classification, and provisioning had exacerbated the problem of NPAs.92 Thus the Narasimham Committee 1991 Report made public what was already a poorly kept secret in the domestic and international banking circles: Indian banks had large folios of NPAs on their balance sheets. The Narasimham Committee 1991 Report recommended that banks maintain

88. See Mukherjee, supra note 80, at 65.
89. See id. at 65.
90. See generally Mistry, supra note 83; see also Bhaumik & Piesse, supra note 78, at 10.
92. See NARASIMHAM COMMITTEE 1991 REPORT, supra note 91; see also Mukherjee, supra note 80, at 72. Among other things, Narasimham Committee 1991 also cleared the way for the entry of new banks and deregulated the expansion of branching networks of existing banks. See Bhaumik & Piesse, supra note 78, at 10.
a risk-weighted capital adequacy ratio of eight percent, mark their assets to the market, identify the problem loans on their balance sheets, and make provisions for bad loans. The Narasimham Committee 1991 Report also recognized that “stricter asset classification norms and provisioning practices . . . reduce the scope for delay in recognizing bad loans.” The Committee therefore recommended instituting a proper definition of NPAs. In addition, the Narasimham Committee 1991 Report recommended setting up Debt Recovery Tribunals (DRTs) to work-out bad loans made by the banks, creating an Asset Reconstruction Fund to remove these non-performing loans from bank balance sheets, and finding ways to recover on these NPAs.

The RBI, on its part, acted swiftly in response to these recommendations, and notified the PSBs of several measures to be adopted. For example, new norms for classification of bank advances were issued. Other
measures, like those aimed at freeing up interest rates on deposits and advances and reducing cash reserve ratios and statutory liquidity ratios for banks were also adopted. In addition, PSBs were allowed to raise equity capital by accessing the capital markets, thereby reducing their dependence on the Government of India. These sets of reforms were completed by the end of Indian fiscal year 1998 and made the Indian banking sector ready for another round of reforms. Thus, the Government of India and RBI set up the second Narasimham Committee in 1998. The terms of reference for second Narasimham Committee were generally about giving recommendations about building a strong foundation for the banking system as well as about more mundane issues like that of technological upgrades.

(1) Standard Assets: Such an asset is not a non-performing asset. In other words, it carries not more than normal risk attached to the business.

(2) Sub-standard Assets: It is classified as non-performing asset for a period not exceeding 18 months.

(3) Doubtful Assets: Asset that has remained NPA for a period exceeding 18 months is a doubtful asset.

(4) Loss Assets: Here loss is identified by the banks concerned or by internal auditors or by external auditors or by Reserve Bank India (RBI) inspection. In terms of RBI guidelines, as and when an asset becomes an NPA, such advances would be first classified as a Sub-standard Asset for a period that should not exceed eighteen months, and subsequently, as a Doubtful Asset. See RESERVE BANK OF INDIA, REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2003-04, 33.

100. Mukherjee, supra note 80, at 72. Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) are two key indicators of the health of the banking sector. Among the steps taken by the Reserve Bank of India were introducing of a Capital Adequacy Norm of 8 percent and institutionalizing the identification of NPAs. In addition, a scheme for gradual reduction of CRR and SLR was adopted. This resulted in a positive impact on the banking sector over a period from 1991 to 1998 so that CRR came down to 11 percent from 15 percent and SLR came down to 25 percent from 38.5 percent. Mukherjee, supra note 80, at 72 n.12.

101. Mukherjee, supra note 80, at 72 n.12. This measure, along with the recommendation of setting up the ARC's by the Narasimham Committee 1998 Report, see infra note 109 and accompanying text, formed the foundation for the legislation enabling securitization of non-performing loans.

102. See Bhaumik & Piesse, supra note 78, at 10. The fiscal year in India begins on April 1, and ends on March 31. Id. at 10 n.11.


104. See Bhaumik & Piesse, supra note 78, at 11.
This was an interesting time for India’s policy makers. The Asian financial crisis had left the economies of South Asia devastated and the future of financial reform in developing countries unclear. In addition, the Tarapore Committee set up by the Reserve Bank of India to “lay a road map” to capital account convertibility had submitted its recommendations. In its recommendations, one of the key assertions by the Tarapore Committee was that the Indian banking sector should be strengthened before making the Indian rupee fully convertible. Thus, with this backdrop, the second Narasimham Committee started drawing up its recommendations targeting the capital adequacy and asset classification norms.

In its recommendations, the second Narasimham Committee made an attempt at resolving the problem of the existing NPAs by way of asset securitization. The Narasimham Committee 1998 Report proposed establishing

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107. See id.; see also Bhaumik & Piesse, supra note 78, at 11.

108. See Narasimham Committee 1998 Report, supra note 103; see also Mukherjee, supra note 80, at 72-73. Some of the key recommendations of the Narasimham Committee 1998 Report targeting capital adequacy norms were:

[M]easures of capital adequacy should take into account market risk of the banks’ assets (including the exchange rate risk of foreign currency held by the banks) and undertake risk management by utilizing “value at risk” models. In addition, the Narasimham Committee also recommended that entire portfolio of government securities with the banks be marked to market within a 3-year period.

Bhaumik & Piesse, supra note 78, at 12 & n.15.

The Narasimham Committee 1998 Report also recommended several proposals on classification assets so as to better reflect their value to the banks’ portfolios. For example, the Narasimham Committee 1998 Report proposed that:

[T]he average level of net NPAs as a fraction of credit outstanding for all banks be reduced to 5 percent or less by [year] 2000 and to 3 percent by 2002. For banks with an international presence, the corresponding targets for gross and net NPAs . . . be 5 percent and 3 percent, and 3 percent and [zero] percent respectively.

Bhaumik & Piesse, supra note 78, at 12 n.14.
an Asset Reconstruction Company (ARC). The ARC would determine a realizable value of NPAs and issue “NPA Swap Bonds,” or banks could issue government guaranteed bonds which would form their Tier II capital. In addition, the Narasimham Committee 1998 Report proposed new standards for asset classification and for income recognition.

Although the Narasimham Committee 1998 Report also expressed concern over the financial health of certain banks, and recommended criteria for identifying other weak banks, it stopped short of proposing any radical steps such as closure of these weaker banks. Furthermore, by recommending that the Government of India reduce its equity in the PSBs to no more than thirty-three percent, and not recapitalize weak banks, it

109. See Narasimham Committee 1998 Report, supra note 103; see also Mukherjee, supra note 80, at 72-73.

110. Mukherjee, supra note 80, at 73.

111. Id.; see also Bhaumik & Piesse, supra note 78, at 12 (“[G]overnment might have to guarantee the bonds issued by the ARCs, the proceeds from which could then be used to buy the bad assets of the banks at a discount.”). Government guarantees are important for such bond issues. This is because such instruments can then be eligible for investments by banks or insurance companies for the purposes of maintaining recommended statutory liquidity ratios. See Mukherjee, supra note 80, at 73.

112. As explained, RBI classifies advances by banks in different subcategories. See Reserve Bank of India, supra note 99. The Narasimham Committee 1998 Report recommended that if an asset was categorized as “substandard” for an 18 month period, it should be converted to the “doubtful” category. Further, this time period should gradually be reduced to 12 months. See Narasimham Committee 1998 Report, supra note 103; see also Mukherjee, supra note 80, at 73.

113. The Narasimham Committee 1998 Report proposed that relevant time period for income recognition be changed from 180 days to 90 days thereby bringing it in sync with international standards. Mukherjee, supra note 80, at 73.

114. See Bhaumik & Piesse, supra note 78, at 13. Some of the PSBs like United Bank of India, United Commercial Bank, and Indian Bank “were clearly underperforming even by the modest standards of the public sector banks.” Id.

115. See Mukherjee, supra note 80, at 73. These criteria were: “(a) accumulated losses and net NPAs exceeding the net worth of the bank, and (b) operating losses less the income on recapitalization bonds . . . negative for three consecutive years.” Id.

effectively provided no advice regarding such PSBs. Therefore the mantle of preparing a policy recommendation in this regard fell upon the Verma Committee of 1999. The terms of reference of the Verma Committee dictated that it “develop[] . . . guidelines for treating weak public sector banks.” Among other recommendations, the Verma Committee Report laid out the details of how to structure and operate the ARCs.

However, while all these steps were well-intended, the results were a far cry from success. Lack of monitoring efforts on part of PSBs—partly because of collusive

117. See Mukherjee, supra note 80, at 73.
119. See Bhaumik & Piesse, supra note 78, at 11.
120. The Verma Committee Report made some recommendations, which, given the delicate political-economic structure of India, can only be termed radical. See Bhaumik & Piesse, supra note 78, at 13-14. For example,

The Verma Committee concluded that the public sector banks were under pressure because of the prudential norms regarding asset classification and provisioning for NPAs, and because of the intensification of competition subsequent to the first phase of banking sector reforms. However, the committee pointed out that the dismal performance of the weak public sector banks was not merely on account of exogenous shocks, but rather that internal problems like limited number of products, poor risk management systems and mediocre service had also contributed. It concluded that mergers and narrow banking are unlikely to resolve the problem of weak banks. Further, while the committee viewed privatization as perhaps the best course of action, it recognized that the cost of restructuring weak state owned banks to make them attractive to private investors would be prohibitively high.

The committee identified persistence of the large volume of NPAs as the biggest challenge facing the weak public sector banks, and proposed, as did the second Narasimham Committee, that ARCs be used as the vehicle for alleviating this problem. Importantly, the committee categorically stated that the weak banks would have to lower costs by reducing the number of staff . . . . It proposed that the staff strength of weak public sector banks be reduced by 25 percent. Moreover, it argued that if VRS [voluntary retirement scheme] fails to reduce the operating cost of these banks, there should be across-the-board wage cuts for their employees.

Id. (footnotes omitted).
121. See Mukherjee, supra note 80, at 72, 74.
activities of the officers and partly because of lack of institutional norms and lack of adopted international best practices—as well as ineffective bankruptcy laws resulted in constraining the recovery process. In addition, lack of well-functioning legal procedures and undue delay in the adjudication process led to a failure of the intended recovery process.

Besides these structural problems, there were institutional difficulties. For example, in 1993, in response to the recommendations of the Narasimham Committee 1991 Report, DRTs were set up to speed the recovery proceeding initiated by banks. However, the performance of DRTs was highly unsatisfactory because of various impediments. One such impediment was the Sick Industrial Companies (Special Provisions) Act (SICA). Banks found it extremely difficult to sue for recovery of money against an industrial entity registered as “sick” under SICA. This was because of—among other reasons—the consent required from the Board for Industrial and Financial Reconstruction (BIFR), created under article 4 of SICA, for the process of recovery.

122. Id. at 75; see also Suryanarayana & Sivaramakrishnan, supra note 81 (“[I]nadequacies in the credit recovery processes arising from the insufficient legal provisions on foreclosure and bankruptcy and long drawn legal procedures . . . placed the lenders at a disadvantage compared to the borrowers.”).

123. See Mukherjee, supra note 80, at 75.

124. Id. at 74.


127. Mukherjee, supra note 80, at 74 & n.15; see also Omkar Goswami, Myth of ARCs, ICFAI READER, Sept. 1999, at 54.


129. Mukherjee, supra note 78, at 72 & n.15. The SICA had an elaborate scheme to “timely detect[,] . . . sick and potentially sick companies owning industrial undertakings,” and for “speedy determination . . . of the preventive,
These vestiges of the “license raj” era of socialist India were an anachronism in the fast-changing world of the liberalized Indian economy and were being used by defaulting companies to their advantage. Fortunately, the Government of India realized that drastic steps were required to expedite the recovery of NPAs, and therefore a bill abolishing SICA, the Sick Industrial Companies (Special Provisions) Repeal Bill was introduced in the Lok Sabha on August 30, 2001. In addition, another bill the Companies (Amendment) Bill of 2001 was also introduced in the Lok Sabha to bring about changes necessary to expedite the recovery of bad loans. Although the bills were presented amid much fanfare, only the Companies


130. For much of the latter half of the twentieth century, India followed a policy of import substitution. This also meant that any person intending to invest in an industry needed to go through bureaucratic machinations of obtaining a “license” for it. Because of the rampant corruption in awarding these licenses, the era came to be known as “license raj,” or the “license reign.”

131. As could be expected in a bureaucracy, the process of referral to the BIFR, and subsequent recovery process, became mired in endless bureaucratic hurdles, and thus the recovery process languished. See, e.g., Good News India, Time Running Out for Old World Tycoons (Nov. 28, 2002), http://www.goodnewsindia.com/index.php/Supplement/article/312/ (last visited Mar. 27, 2007).

132. Lok Sabha is the lower house in the bicameral Indian Parliament.


135. See MINISTRY OF FINANCE, ECONOMIC SURVEY 2001-2002, Chap. 7.1, available at http://indiabudget.nic.in/es2001-02/indus.htm; TENTH FIVE YEAR PLAN 2002-07, PLANNING COMMISSION OF INDIA, Chap. 7.1, available at http://planningcommission.nic.in/plans/planrel/fiveyr/10th/volume2/v2_ch7_1.pdf (“In order to solve the problems experienced and to reduce the time taken in the winding up/liquidation of companies under the Companies Act 1956 . . . a Bill namely the Companies (Amendment) Bill, 2001 has been introduced in the Lok Sabha on August 30, 2001. [In addition, t]he Abolition of Sick Industrial Companies Act (SICA) bill was introduced in Lok Sabha on August 30, 2001. . . . As these Bills get enacted the process of industrial restructuring should become
(Amendment) Act\textsuperscript{136} was passed in 2001; the other languished in the parliamentary system until 2003 when the Sick Industrial Companies (Special Provisions) Repeal Act finally became law.\textsuperscript{137}

Amidst all this, performance of PSBs continued to be adversely affected, partly as a result of the delicate political economic structure of India, partly because of competition from foreign banks, and partly because of inherent structural deficiencies.\textsuperscript{138} This built up a sense of urgency in the Indian bureaucratic and political circles. All the frenetic activity and public debate over NPAs resulted in a rather drastic step, the promulgation of “The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002” (SARFAESI),\textsuperscript{139} by the Government of India.\textsuperscript{140} Suddenly, there was an easier and faster\textsuperscript{.}.


\footnote{137. The Sick Industrial Companies (Special Provisions) Repeal Act, No. 1 of 2004, available at http://indiacode.nic.in.}

\footnote{138. These deficiencies included, for example, problems in customer service, outdated information and telecommunication technology, and over-staffing, and were pointed out by the Narasimham Committee 1998. See Mukherjee, supra note 80, at 73. Over the years, the Government of India commissioned several committees that reported their findings on reform of the financial sector and pointed out some of these problem areas. See T. N. Srinivasan, Eight Lectures on India’s Economic Reforms, 61, 66-70 (2000).}

\footnote{139. The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, Ord. 2 of 2002 (Ministry of Law, Justice, and Co. Affairs, Legislative Dep’t). The Government of India promulgated another ordinance, see infra note 140 (discussing what is an ordinance), on the expiration of SARFAESI, called the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (Second) Ordinance, 2002 (Ord. 3 of 2002), identical in all respects to the original SARFAESI. In order to facilitate the reader’s comprehension of the big picture, I use SARFAESI for both the first and the second ordinance, as well as for the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, No. 54 of 2002, see infra note 143, which is the Act of Parliament adopted to enforce the scheme of SARFAESI ordinances.}

\footnote{140. An ordinance is a legislative device in India used to bypass the usual machinations associated with the parliamentary system. In a democracy like India—where there is always a possibility that a bill will die in the parliamentary quagmire that a multi-party system can generate—this can be a very handy tool, at least for the short term. I hope this cynical view does not take the reader’s eyes away from the genius of this device. Article 123 of the Indian Constitution deals with the legislative powers of the President of India.}
enhancement of creditors’ rights, which empowered “banks and financial institutions to take possession of the securities and sell them without going through the protracted judicial process.”

With this background in place, I proceed to analyze the legal developments related to resolving the existing NPAs problem in India by transferring the risks associated with these NPAs to willing investors in capital markets. In other words, I analyze key issues—some addressed, others perhaps neglected—in SARFAESI, which has since been adopted as an act of Parliament. However, before delving into this discussion, I venture to explain securitization, first generally, and then using NPAs as an asset class.

II. ASSET SECURITIZATION

Part A provides a basic review of the asset securitization technique and describes a typical asset

INDIA CONST. art. 123 [hereinafter the Constitution]. In order for the President to promulgate an ordinance under article 123, four conditions must be met. These are:

i. both Houses of Parliament must not be in session,

ii. circumstances must exist which render it necessary for the President to take immediate action,

iii. he must be satisfied that the circumstances require him to act in that manner, and

iv. the provisions contained in the Ordinance must be within the legislative competence of Parliament to enact and must not violate any of the fundamental rights or prohibitions contained in the Constitution.

GAE, supra note 43, at 4. An ordinance promulgated under article 123 has the same force and effect as an Act of Parliament, but only for a limited period of time. Therefore an ordinance “ceases to operate at the expiration of six weeks from the re-assembly of Parliament. Id. at 6. Unless the ordinance is withdrawn by the President or is disapproved by resolutions passed by both Houses of Parliament, the Ordinance is binding on both Houses of Parliament. Id. Passage of an ordinance usually acts symbolically to indicate the desperate nature of the situation which an ordinance covers. Compare supra note 71, and accompanying text, with conditions that led to the passage of the SARFAESI.

141. The term “securities” is used here in the sense of collateral.

142. Mukherjee, supra note 80, at 75.

securitization deal. Part B discusses securitization of NPAs and critical issues in such transactions.

A. Basics of Asset Securitization

Defining securitization is a formidable task. It means different things for different people. As one commentator puts it, the concept of securitization is like the elephant in the fable of three blind men who attempt to describe it. However, in its most fundamental form, securitization is “reducible to a search for liquidity,” and can be viewed as a form of disintermediation so that a borrower may access the financial markets directly without the intermediation of commercial banks. Among these pithy generalizations, a rather standard definition from early days of securitization emerges. Accordingly, Securitization is:

[T]he sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.

145. Id. at 1373 n.16.
146. See James P. Holdcroft, Jr., Comment, in Structural Change in Banking, 338, 338 (Michael Klausner & Lawrence J. White eds., 1993) (discussing Tamar Frankel, Securitization: Structured Financing, Financial Assets Pools, and Asset-Backed Securities by Tamar Frankel (1991) and noting: “[S]ecuritization as a concept is very much like the elephant in the fable: Securitization can mean quite different things to different people.”).
Securitization of assets as a financing tool has come a long way since the 1970s when the first securities backed by residential mortgages were introduced in the United States debt markets. Although technically, securitization is a financing technique in which financial assets, in many cases themselves less liquid, are pooled and converted into instruments that may be offered and sold in the capital markets. In a basic securitization structure, an entity, often a financial institution and commonly known as a 'sponsor,' originates or otherwise acquires a pool of financial assets, such as mortgage loans, either directly or through an affiliate. It then sells the financial assets, again either directly or through an affiliate, to a specially created investment vehicle that issues securities 'backed' or supported by those financial assets, which securities are 'asset-backed securities.' Payment on the asset-backed securities depends primarily on the cash flows generated by the assets in the underlying pool and other rights designed to assure timely payment, such as liquidity facilities, guarantees or other features generally known as credit enhancements. The structure of asset-backed securities is intended, among other things, to insulate ABS investors from the corporate credit risk of the sponsor that originated or acquired the financial assets. Capital markets differentiate between securitized products that are backed by mortgages (mortgage-backed securities, or "MBS") and those that are backed by other kinds of assets (asset-backed securities, or "ABS"). The first securitized products in the United States were "agency" MBS, see Andrew Carron et al., CREDIT RATINGS FOR STRUCTURED PRODUCTS: A REVIEW OF ANALYTICAL METHODOLOGIES, CREDIT ASSESSMENT ACCURACY, AND ISSUER SELECTIVITY AMONG THE CREDIT RATING AGENCIES 9-10 (National Economic Research Associates, 2003) [hereinafter CREDIT RATINGS REVIEW], issued by the federal agencies created under the Federal Home Loan Mortgage Corporation Act, Title III of the Emergency Home Finance Act of 1970, Pub. No. 91-531, 303(a) Stat. 450, 452 (codified as amended at 12 U.S.C. 1452(a) (2000)). These agencies, the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac"), Federal National Mortgage Association (FNMA, or "Fannie Mae"), and the Government National Mortgage Corporation, (GNMA or "Ginnie Mae"), collectively called the Government Sponsored Entities or GSEs, see Claire A. Hill, Securitization: A Low-Cost Sweetener for Lemons, 74 WASH. U. L.Q. 1061, 1106-07, 1113 n.213 (1996), bought qualifying home mortgages from lenders, pooled these mortgages, and issued securities backed by these pools in the capital markets. See CHRISTINE A. PAVEL, SECURITIZATION: THE ANALYSIS AND DEVELOPMENT OF THE LOAN-BASED/ASSET-BACKED SECURITIES MARKET 6 (1989); STEVEN L. SCHWARZ ET AL., SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 2 (2004). Later, this model of pooling together assets to issue marketable securities was replicated by "non-agency" or "private-label" issuers. CREDIT RATINGS REVIEW, supra, at 10. Currently, the MBS market is one of the largest among the various asset classes that are being securitized. See infra note 153; Mark Adelson & David Jacob, Thirty Years Later Securitization Is Still Good for America, (Nomura Sec. Int'l, Inc. (Mar. 15, 2002, New York,
existed in some form before the modern securitized products, it is principally an American financing technique. In its early years, securitization was almost always used to finance relatively simple, standardized, and self-liquidating assets such as mortgage loans; today securitization has expanded in both its applications and in its global outreach. Securitization of a variety of cash flows is now frequently employed in more complicated financing structures around the world. Securitization, amidst all


153. The early securitization model has been replicated by both quasi-governmental agencies as well as the private sector to securitize different kinds of cash flows. Hence, securities backed by pools of student loans (first originated by the Student Loan Marketing Association (SLMA or “Sallie Mae”), see Tamar Frankel, Securitization: Structured Financing, Financial Assets Pools, and Asset-Backed Securities by Tamar Frankel 37 (1991)), farm loans, automobile loans, commercial leases, credit card receivables, and trade receivables, among other kinds, have been issued. Of course, with appropriate guarantees and credit enhancements in place, virtually any asset class with any risk profile can be securitized. Currently, the MBS market is one of the largest among the various asset classes that are being securitized. See Scott & Wellons, supra note 148, at 261 (noting that in the United States, by the mid-1990s, there were over $1 trillion in outstanding issues of MBS.). In the year 2003 alone, Residential MBS accounted for over $215 billion in new issuance, STRUCTURED DEBT YEARBOOK 2004: AN OVERVIEW OF THE ABS, MBS AND CDO MARKETS 77 (Banc One Capital Mkts., Inc., 2004), while securities backed by vehicles accounted for about $78 billion in new issues. Id.

154. Complexity of securitized (or “structured”) products is limited only by the need, or imagination, if you will, of players in the market. Securitization of virtually any kind of cash flow is theoretically—and, it seems, practically—possible. See supra note 153. Among the more exotic asset classes that are being securitized include music copyright royalties, see Teresa N. Kerr, Bowie Bonding in the Music Biz: Will Music Royalty Securitization Be the Key to the Gold for Music Industry Participants?, 7 UCLA ENT. L. REV. 367 (2000), tax arrears, see Alberto M. Ramos, Government Expenditure Arrears: Securitization and Other Solutions (Int’l Monetary Fund, Working Paper No. WP/98/70, 1998), available at http://www.imf.org/external/pubs/ft/wp/wp9870.pdf; drug royalties,
this frenetic activity surrounding it, however, still remains largely an innovation.155

Despite the complexity of present day securitization structures, a typical securitization deal156 involves a firm


155. Although securitization, as we know it, is almost three decades old, the frontier is rapidly changing. To put things in perspective, the Securities and Exchange Commission came out with a comprehensive set of regulations aimed at “address[ing] comprehensively the registration, disclosure and reporting requirements for asset-backed securities” only recently. See Regulation AB, 70 Fed. Reg. 1506, 1508 (Jan. 7, 2005) (to be codified at 17 C.F.R. pt. 210, 228-229, 232, 239, 240, 242, 245, and 249). Further, in countries like India, it is only in the past few years that the use of securitized products has gained momentum. See ICRA RATING FEATURE, UPDATE ON THE INDIAN STRUCTURED FINANCE MARKET (July 2005), http://www.icraratings.com/rating_article/2005-July-PRmarketupdateFY05.pdf; see also Chakravarthi Anand, Securitization Markets: Indian and Global Scenario, GT NEWS, June 21, 2004 (originally published in ICFAI Reader), http://www.gtnews.com/article/5535.cfm (last visited Fed. 14, 2007) (“[Securitization] is still in its nascent stages, with securitized assets as low as about 2% of all debt outstanding.”).

AN ELEPHANT'S TALE

(Originator) identifying and selling its rights to receive certain future monies (Receivables) to a special purpose entity.\textsuperscript{157} By isolating these assets from the selling entity and transferring the assets to a special purpose vehicle,\textsuperscript{158} the Originator can obtain present cash flow.\textsuperscript{159} This special purpose vehicle then issues marketable securities, usually bonds, which are most certainly rated higher than the debt of the entity selling the assets to the special purpose vehicle.\textsuperscript{160} Depending upon the performance characteristics

\begin{footnotesize}
\begin{enumerate}
\item[157.] Kerr, supra note 154, at 370; see also Peter J. Lahni IV, Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation, 9 AM. BANKR. INST. L. REV. 815, 816-17 (2001).

\item[158.] An originator or sponsor may create a legal entity, an SPV (sometimes referred to as a special purpose entity (SPE)), by transferring assets to the SPV to carry out some specific purpose, circumscribed activity, or a series of such transactions. See Gary Gorton & Nicholas S. Souleles, Special Purpose Vehicles and Securitization 1, (Nat’l Bureau of Econ. Research, Working Paper No. 11190, 2005), available at http://www.nber.org/papers/w11190. SPVs have no purpose other than the transaction(s) for which they were created, and they can make no substantive decisions; articles of incorporation of such entities circumscribe their activities. Id. The SPV sponsoring firm maintains control over the business decisions while the financing is done in SPVs that are passive; they cannot make business decisions. Id. Furthermore, the SPVs are not subject to bankruptcy costs because they cannot go bankrupt, as a matter of design. Id.

\item[159.] Kerr, supra note 154, at 370.

\item[160.] Securitization transactions where assets are removed from an originator's balance sheet are called “true sale” securitizations. Such transactions, for obvious reasons, are also called off-balance sheet transactions. However, there are “synthetic” securitizations also which combine features from true sale securitizations as well as those of credit derivatives. Thus by using credit derivatives like credit default swaps (CDS), credit-linked notes (CLN), and total rate of return swap (also called total return swap or TRS), commercial effects of true sale securitization can be achieved. For a general discussion of credit derivatives, see J.P. Morgan, THE J.P. MORGAN GUIDE TO CREDIT DERIVATIVES, http://www.investinginbonds.com/assets/files/Intro_to_Credit_Derivatives.pdf (discussing various credit derivative instruments listed above as well as a specific discussion of BISTRO (Broad Index Secured Trust Offering), the synthetic securitization structure developed by J.P. Morgan that is used to transfer tranched credit exposure to large, diversified portfolios of commercial or consumer loans from the originator to the investors); LEHMAN BROS., THE LEHMAN BROTHERS GUIDE TO EXOTIC CREDIT DERIVATIVES, http://www.investinginbonds.com/assets/files/LehmanExoticCredDerivs.pdf. Such synthetic securitizations work for changing the originator’s credit risk position, and do not necessarily involve removing the assets off of the balance
\end{enumerate}
\end{footnotesize}
of the underlying assets, various credit enhancements may be used so as to assure the investors of the returns associated with these securities. One key issue in these transactions is to ensure that the transfer of assets results in isolation of the assets from the seller and that these


161. In an ABS transaction, it is necessary for the issuer to satisfy the purchasers of the credit quality of the securities. Credit enhancements are provided by the sellers for this particular purpose. Credit enhancements may be internal, given by the originator, such as subordination of interest, over-collateralization, excess spread, reserve account, and collateral interest; or may be external, such as a letter of credit, agreement to purchase defaulting receivables, financial guarantees (sometimes called liquidity facilities) and surety bonds. See J. David Cummins, Securitization of Life Insurance Assets and Liabilities 6, Jan. 3, 2004, http://www.huebnergeneva.org/documents/cumminssecuritization.pdf. See generally Oldfield, supra note 156; Jennifer O. Quisenberry, Securitization of Non-Traditional Asset Types: An Investor’s Perspective, in HANDBOOK OF STRUCTURED FINANCIAL PRODUCTS, supra note 154, at 21; Steven L. Schwarz, The Alchemy of Asset Securitization, 1 STAN. J.L. BUS. & FIN. 133 (1994); Warren Lee, Future Applications of Securitization in Asia (Nov. 13, 2003) (unpublished PowerPoint presentation, available at http://law.hku.hk/aifl/ABMF/Lee%20Securitisation.pdf).
assets do not recourse back to the seller in the event of bankruptcy.\textsuperscript{162}

B. \textit{Securitizing NPAs}

The nature of the banking industry has changed rapidly over the past few decades, and asset-backed securitization has contributed significantly to this change.\textsuperscript{163} Over the years, asset-backed securitization has become an “integral part of . . . modern banking activities,”\textsuperscript{164} so much so that formal models are being developed to understand the effects of asset-backed securitization on the capital structure of banks.\textsuperscript{165}

An increase in default rates of repayment of loans by debtors is the primary motivation for Originators to securitize their portfolios of non-performing loans.\textsuperscript{166} Such increased default rates negatively affect a bank’s financial

\textsuperscript{162} Courts, at least in United States, focus “on the presence of recourse for credit losses as the primary factor in determining whether there has been a ‘true sale.’” Stuart M. Litwin & William A. Levy, \textit{New Developments in Equipment and Auto Lease Financing: Securitization, Leveraged Leasing and Titling Trusts} 6 (2000), available at http://www.securitization.net/pdf/litwin_levy2.pdf. If the transfer of financial assets is with recourse, it is usually not considered a true sale “unless the amount of the recourse is \textit{de minimis}.” \textit{Id.}


\textsuperscript{164} \textit{Id.} at 355; see April K. Rinne, An Analysis of the Treatment of Asset Securitization under the Proposed Basel II Accord and the U.S. Banking Agencies’ Advance Notice of Proposed Rulemaking (ANPR) 5 (Apr. 23, 2004) (unpublished M.A. thesis, Tufts University), http://fletcher.tufts.edu/research/2004/Rinne-April.pdf (“The securitization process . . . has the capacity to significantly reduce an entity’s overall risk profile and subsequently its capital holding requirement. As a result, banks that engage in securitization are likely to have lower capital ratios than banks with no securitization activities. In turn, banks with lower capital ratios are likely to have a lower overall cost of funds, which in turn will impact the banks’ profitability and consumers’ access to credit.”)

\textsuperscript{165} See, e.g., Wolfe, \textit{supra} note 163; see also Eugene A. Imhoff, Jr., \textit{Asset Securitization: Economic Effects and Accounting Issues}, ACCT. HORIZONS, Mar. 1992, at 9-11.

Securitization permits the originating financial institution to transfer the credit risks associated with its NPAs portfolio to willing investors in capital markets, thereby positively influencing its balance sheet. By securitizing such loans and removing these assets from their balance sheets, the Originator limits any further losses. This is because any future losses will be limited to the extent of credit enhancements provided by the Originator. In disposing the NPAs in such a manner, the

167. See id.

168. See Edward J. Park, Comment, Allowing Japanese Banks to Engage in Securitization: Potential Benefits, Regulatory Obstacles, and Theories for Reform, 17 U. Pa. J. Int’l Econ. L. 723, 729 (1996). Proceeds of a securitization transaction can influence the various key financial and accounting measures of bank health such as Return on Assets (RoA), Return on Equity (RoE), as well as Capital to Assets Ratio (CAR). Id. Securitization also makes it easier for the banks to comply with the capital requirements under the Basel Accord capital adequacy guidelines. Thus securitization can indeed help in more than one way. See id. at 724, 728-729 (“Securitization has provided borrowers with lower interest rates, investors with greater liquidity, banks with lower funding costs, and the economy with a lower cost of capital.”); see also JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 12-23 (1988). Indeed, the prevalent view in India is that securitization is a panacea of sorts. See Reserve Bank of India, REPORT OF THE IN-HOUSE WORKING GROUP ON ASSET SECURITISATION, §3.20 (1999) (concluding the chapter with a view that “[s]ecuritisation provides capital relief, improves market allocation efficiency, improves the financial ratios of the FIs, can create a myriad of cash flows for the investors, suits risk profile of a variety of customers, enables the FIs to specialise in a particular activity, shifts the efficient frontier to the left, completes the markets with expanded opportunities for risk-sharing and risk-pooling, increases liquidity, facilitates asset-liability management, and develops best market practices”). For further discussion of how securitization activities may help banks realize more profits and enhance their capital and financial ratios, see Shenker & Colletta, supra note 144, at 1395-96, 1396 n.131.

169. Securitization transactions where assets are removed from an originator’s balance sheet are called “true sale” securitizations or off-balance sheet transactions. Under a true sale securitization, the transaction can be treated as a “sale” of underlying assets. “Sale” may have different meaning for accounting, taxation, and bankruptcy purposes. However, generally, the transfer of assets must qualify as a sale of assets in the relevant jurisdiction rather than a secured loan, thereby enabling the originator to remove these assets from its balance sheet. See Shengzhe Wang, True Sale Securitization in Germany and China, §1 n.1 (Dec. 15, 2004) (unpublished LLM thesis, Johann Wolfgang Goethe University) (on file with the Buffalo Law Review).

170. See Cao, supra note 166, at 582. Such credit enhancements may take various forms. See supra note 161. When underlying assets in a securitization transaction are NPAs, usually an originator will have to provide some kind of
risks and rewards of the underlying problem of NPAs are transferred and spread amongst market participants.171

Commercial success of such securitizations is dependant on the assurance of a proper return to investors.172 In order to provide the return promised to the investors, the servicer of the securities must be able to extract sufficient value from either the asset pool or from loan collaterals.173 Further, in order to reach out to a large number of investors with different risk appetites, it becomes necessary to structure the deal in such a way so as to cater to different classes of investors.174 Finally, a crucial issue is meeting the assurance of proper returns through the ability to generate the predicted cash flows.175 Because NPAs by their very nature have high delinquency and default rates, recovery of these loans—coming via refinancing, restructuring, or liquidation, so as to generate cash flows in a predicable manner—is an important factor in meeting the need of assured returns for the investors.176 With these constraints always on the horizon, the role of
guarantee or credit enhancement to the transaction. This is so as to be able to obtain a good rating from any of the rating agencies providing an opinion on the transaction and hence be able to issue securities backed by these NPAs at a low spread from risk free securities such as government treasury bonds. See Cao, supra note 166, at 582. Credit rating agencies consider a number of factors in rating a securitization transaction backed by NPAs. Among other criteria, some important ones are (i) the nature of obligors i.e., quantitative and qualitative characteristics of the obligor’s credit worthiness; (ii) recovery rates of NPAs; (iii) structural considerations like availability of liquidity facility and credit enhancements. See Letter from Stephen W. Joynt, President and Chief Executive Officer, Fitch Ratings Inc to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Nov. 12, 2002), http://www.sec.gov/news/extra/credrate/fitchratings1.htm; see also Cao, supra note 166, at 583 & n.124; STEVEN L. SCHWARCZ ET AL., supra note 150, at 5.

171. Cao, supra note 165, at 582.

172. In other words, securities backed by non-performing loans must be able to provide returns commensurate with the risk undertaken. See id. at 583.

173. See id.

174. See id. ("To attract investors with different risk appetites, an originator may structure the transaction in a way that the same asset pool to generate [sic] several classes of notes with hierarchical seniority and different credit ratings").

175. See id.

176. See id. at 584.
the financial institution that services the securities backed by these NPAs is crucial.177

It is this particular constraint—banks’ ability, or rather inability, to extract value from the pledged collateral in the event of a loan default—that hampered the Indian banking sector’s growth. As noted elsewhere,178 the protracted legal battles made it extremely difficult to foreclose on the pledged collateral in the event of a default. This meant that banks did not usually have the confidence to engage in such a course.179 Under these circumstances, the NPAs in the Indian banking sector continued to grow.180 So when the Indian government decided to legislate SARFAESI and enhance creditors’ rights, thereby making it easier for the banks to be able to extract value from the pledged collaterals, it killed several birds with a single stone. The legislative response—passage of SARFAESI—and asset reconstruction activities in India post-SARFAESI are discussed next.

177. See id. ("[T]he originator-service (usually a financial institution) plays a key role in a distressed loan securitization. . . . [T]he originator is the entity responsible for creating the asset pool from a suitable portfolio. In addition, investors also rely heavily on the originator to channel the cash flow generated from the asset pool to the SPV for interest distribution. Furthermore, the originator often assumes the servicer’s role given its experience and skills in collecting debts and enforcing creditor’s rights. In the event of loan defaults, the originator should take the best course of action to maximize recoveries for the investors’ benefit. In servicing securities backed by distressed loans, the originator’s main task is not one of selecting and monitoring loans that are expected to be performing. Rather, the focus is on choosing weak loans with good recovery prospects and on actively working with the defaulted borrowers, the lending group, bankruptcy courts, and any other parties in order to generate the necessary cash flow to service the required ABS payments. To increase its ability to better service the asset pool(s), the originator may also transfers [sic] a part of servicing function to a reliable outside specialist.") (internal citations omitted).

178. See supra Part I.D; see also infra Part III.


180. See supra note 79.
III. SARFAESI AS THE "MAGIC WAND"—EXTRACTING VALUE FROM NPAS

Under the legal system prevalent before the enactment of SARFAESI, creditors could take possession of collateral without the intervention of the courts only in certain specific cases. SARFAESI changed that. SARFAESI is a broad piece of legislation with a three-pronged approach. It makes it easier for the Secured Creditor to enforce its Security Interest; it provides for the transfer of NPAs to the ARCs so that the ARCs can dispose of

181. Suryanarayana & Sivaramakrishnan, supra note 81, at 1.
182. See infra note 193, and accompanying text.
183. See Anand, supra note 155 ("In this Act [SARFAESI], the provisions of securitization have been clubbed with provisions of asset reconstruction and enforcement of security interest. Though these provisions are heterogeneous in nature, one thing that is common to them is that they are related to banks and financial institutions.").
184. See Srivastava, supra note 179.
185. Under SARFAESI,
[A] “Secured Creditor” means any bank or financial institution or any consortium or groups of banks or financial institutions and includes:
(i) debenture trustee appointed by bank or financial institution; or
(ii) securitisation company or reconstruction company; or
(iii) any other trustee holding securities . . . in whose favour security interest is created for due repayment by any borrower of any financial assistance.
§2(1)(zd).
186. Under SARFAESI,
“[S]ecurity interest” means right, title and interest of any kind whatsoever upon property, created in favour of any secured creditor and includes any mortgage charge, hypothecation, assignment other than those specified in section 31.
§2(1)(zf).
Exceptions provided under section 31 deal with liens on goods, movables, aircrafts and marine vessels, as well as provide relief for agricultural and other small borrowers. For a discussion of how SARFAESI allows for easier recovery process in the event of loan default, see infra Part III. B.
187. Under SARFAESI, a non-performing asset, or NPA, is “an asset or account of a borrower, which has been classified by a bank of [sic] financial institution as sub-standard, doubtful or loss asset, in accordance with the directions or guidelines relating to asset clarifications issued by the Reserve Bank.” § 2(1)(o).
them and realize the proceeds;\textsuperscript{189} and finally it provides for "a legal framework for securitisation of assets."\textsuperscript{190} Part A explains the regulatory scheme embodied in SARFAESI that allows for creating asset-backed securities based on NPAs and how it is being used to extract value from NPAs. Part B addresses some of the potential problem areas in SARFAESI that may derail this experimentation.

A. Asset Reconstruction and Securitization under SARFAESI

The Government of India promulgated SARFAESI as a broadside attack on the NPAs problem in India. To achieve the desired results, the Government of India included in SARFAESI not only a framework for regulating securitization activities in India,\textsuperscript{191} but also a restructured “framework of debt workouts in favour of lenders and against the borrowers.”\textsuperscript{192} Thus, the Indian government worked to close the legal loopholes that had earlier made it difficult for the banks to extract value from the pledged

\textsuperscript{188} Under SARFAESI, “‘reconstruction company’ means a company formed and registered under the Companies Act, 1956 for the purpose of asset reconstruction,” and “‘securitisation company’ means any company formed and registered under the Companies Act, 1956 for the purpose of securitisation.” §§ 2(1)(v), (za).

\textsuperscript{189} Under SARFAESI, “‘asset reconstruction’ means acquisition by any securitisation company or reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance.” § 2(1)(b).

\textsuperscript{190} Srivastava, supra note 179.

\textsuperscript{191} See SARFAESI pmbl (“An ordinance to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected therewith or incidental thereto.”). It is interesting to note how Indian lawmakers have defined securitization. According to the definitions adopted by SARFAESI, “‘securitisation’ means acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise.” § 2(1)(2).

\textsuperscript{192} C.P. Chandrasekhar, \textit{NPAs in India’s Banks: Debt Default as Strategy}, May 19, 2003, http://www.macroscan.org/cnr/may03/print/prnt190503NPA.htm. This is because, as noted previously, under the provisions of SICA, the companies had the option to take refuge under the BIFR, which would keep lenders away in spite of default. \textit{See id.}
collateral in the event of default, and to allow willing counterparties to share the risk associated with NPAs.

Under SARFAESI, if a loan becomes non-performing, the secured creditor may, by providing a notice of sixty days, become entitled to exercise the rights available to it under SARFAESI. SARFAESI provides that upon receiving such notice, if the borrower fails to discharge its liability in full, the secured creditor may take possession of

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193. See infra Part III.A. The governing law in such cases remained The Transfer of Property Act, 1882, No. 4 (as amended) (“The Transfer of Property Act”). Section 69 of the Transfer of Property Act provides that:

A mortgagee, or any person acting on his behalf, shall, subject to the provisions of this section, have power to sell or concur in selling the mortgaged property, or any part thereof, in default of payment of the mortgage-money, without the intervention of the Court, in the following cases and in no others, namely:--

(a) where the mortgage is an English mortgage

(b) where a power of sale without the intervention of the Court is expressly conferred on the mortgagee by the mortgage-deed and the mortgagee is the Government;

(c) where a power of sale without the intervention of the Court is expressly conferred on the mortgagee by the mortgage-deed and the mortgaged property or any part thereof was, on the date of the execution of the mortgage-deed, situate[d] within the towns of Calcutta, Madras, Bombay or in any other town or area which the State Government may, by notification in the Official Gazette, specify in this behalf.

The “English mortgage” mentioned here is the kind of mortgage in which the mortgagor promises to repay the borrowed funds on a specific date, and as collateral transfers the mortgaged property “absolutely to the mortgagee,” however, with the provision that the mortgagee will re-transfer the property to the mortgagor upon payment of the borrowed funds as agreed. See Anupam Srivastava, supra note 179. These regulations meant that for all practical purposes, the only route available to banks to foreclose on the pledged collateral was to enforce their rights through the slow and long-drawn out process in the courts. See id.

194. SARFAESI provides that:

Where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt is classified by the secured creditor as non-performing asset, then the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor shall be entitled to exercise all or any of the rights under sub-section (4).

§ 13(2).
the secured asset, or may take over the management of the secured asset by appointing a manager.\textsuperscript{195} However, in case multiple secured creditors are owed debt by the borrower, such rights cannot be exercised by these creditors unless secured creditors with rights to three-fourths of the outstanding debt agree to an action.\textsuperscript{196} SARFAESI further makes such an action binding on all the secured creditors.\textsuperscript{197}

For promoting asset-backed securities based on NPAs, SARFAESI permits setting up of ARCs to take over the NPAs that have accumulated in the Indian banking

\textsuperscript{195} Under SARFAESI,

In case the borrower fails to discharge his liability in full within the period specified in sub-section (2), the secured creditor may take recourse to one or more of the following measures to recover his secured debt, namely:-

(a) take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset;

(b) take over the management of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale and realise the secured asset;

(c) appoint any person (hereafter referred to as the manager), to manage the secured assets the possession of which has been taken over by the secured creditor;

(d) require at any time by notice in writing, any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, so much of the money as is sufficient to pay the secured debt.

\textsuperscript{\S} 13(4).

\textsuperscript{196} SARFAESI, \textsuperscript{\S} 13(9) provides that:

In the case of financial [sic] of a financial asset by more than once [sic] secured creditors or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any or all of the right [sic] conferred on him under or pursuant to sub-section (4) unless exercise of such right is agreed upon by the secured creditors representing not less than three-fourth in value of the amount outstanding as on a record date and such action shall be binding on all the secured creditors.

\textsuperscript{\S} 13(9).

\textsuperscript{197} See id.
sector.\textsuperscript{198} However, SARFAESI does not allow the Banks\textsuperscript{199} and various Financial Institutions\textsuperscript{200} to create special purpose vehicles\textsuperscript{201} for securitization and asset reconstruction transactions. Instead, banks and financial institutions may set up ARCs.\textsuperscript{202} ARCs are required to maintain a capital adequacy ratio of at least fifteen percent of their total risk weighted assets.\textsuperscript{203} Further, any ARC seeking registration with the RBI is required to own the fund of at least two crore rupees (Rs. Twenty Million).\textsuperscript{204}

ARCs may purchase NPAs from banks and financial institutions and then set up one or more trusts to issue

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\textsuperscript{199} Under SARFAESI, a “bank means - (i) a banking company: [sic] or (ii) a corresponding new bank; or (iii) the State Bank of India; or (iv) a subsidiary bank; or (v) such other bank which the Central Government may, by notification, specify for the purposes of this Ordinance.” § 2(1)(c).

Furthermore, the “banking company” referred to in this definition has “the meaning “assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949.” § 2(1)(d). According to the Banking Regulation Act, No. 10 of 1949, a banking company is “any company which transacts the business of banking” in India. § 3(c).

\textsuperscript{200} Under SARFAESI, ‘Financial Institutions’ means -

(i) a public financial institution within the meaning of section 4A of the Companies Act, 1956;

(ii) any institution specified by the Central Government under sub. Clause (ii) of clause (h) of section 2 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993;

(iii) International Finance Corporation established under the International Finance Corporation (Status, Immunities and Privileges) Act, 1958;

(iv) Any other institution or non-banking financial company as defined in clause (f) of section 45-1 of the Reserve Bank of India ‘Act, 1934, which the Central Government may, by notification, specify as financial institution for the purposes of this Ordinance.

§2 (1)(m).

\textsuperscript{201} See supra Part II.A.

\textsuperscript{202} See SARFAESI § 3.

\textsuperscript{203} See SARFAESI § 3(1)(B).

\textsuperscript{204} See id.
Security Receipts. Under SARFAESI, such sales may occur on “without recourse” basis or “with recourse” basis. However ARCs “pay” for such purchases, not in cash, but rather by issuing security receipts to the banks for a discounted value of the debt. Although these security receipts do not carry a fixed rate of interest or even a repayment schedule, in practical terms, the NPAs on the banks’ balance sheets are replaced by these debt securities, which count as investments for regulatory purposes. In addition, the requirement for setting aside potential profits as provisions for NPAs becomes moot.

205. According to SARFAESI, “‘security receipt’ means a receipt or other security, issued by a securitisation company or reconstruction company to any qualified institutional buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitization.” § 2(1)(zg). Compare these definitions with the ones used in Regulation AB, 70 Fed. Reg. 1506, 1508 (Jan. 7, 2005) (to be codified at 17 C.F.R. pt. 210, 228-229, 232, 239, 240, 242, 245, and 249). In addition, in stressing that such securitized products can be marketed to only sophisticated institutional investors, the “qualified institutional buyers,” § 2(1)(u); see also infra note 223, SARFAESI makes it very clear that such instruments are outside the realm of public investing. This emphasis in regulating who can invest in these sophisticated products is in sync with similar emphasis in financially developed markets like the United States.

206. See Reserve Bank of India, Guidelines to Banks/FIs on Sale of Financial Assets to Securitisation Company (SC)/Reconstruction Company (RC) (created under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002) and Related Issues—Annexure, http://www.rbi.org.in/home.aspx. The guidelines suggest that “without recourse” means that the “entire credit risk associated with the financial assets [is] being transferred to SC/RC” and “with recourse” means that upon non-realization, part of the assets will revert back to the seller bank or financial institution. Id. § 4(a).

207. See SARFAESI § 5(1)(a); see also India’s Credit Clean-up, The Banker, (July 4, 2005), http://www.thebanker.com/news/printpage.php/aid/3030/India’s_credit_clean-up.html (last visited Jan. 11, 2006).

208. See India’s Credit Clean-up, supra note 207.

209. See id.

210. See Chandrasekhar, supra note 192; see also Indian Bad-Debt Buyer Awaits Foreign Funds, Reuters (June 15, 2005), http://arcil.co.in/ARCIL/HOME/ASP/ARCIL_News_brief.asp?MenuID=5&News_ID=54 (“Provisioning is only helping the bank to the extent of removing the weakness from the balance sheet. If you have a dirty room and you close the door, the dirt doesn’t go away; only maybe the foul smell doesn’t spread in the house.” (quoting Rajendra Kakker, Chief Executive Officer, Asset Reconstruction Company (India) Ltd.).)
B. Securitizing NPAs in India: Potential Problems Post-SARFAESI

In India, prior to SARFAESI, distribution of NPAs remained skewed in favor of big borrowers. Therefore, it was not a surprise that, in response to the Indian government’s efforts to enhance creditors’ rights, big borrowers that had been reaping the benefits of a weak debt recovery regime attacked the constitutional validity of SARFAESI. However, in Mardia Chemicals, the Supreme Court of India rejected this attack on the constitutionality of SARFAESI. In its judgment dated April 8, 2004, the Supreme Court of India ruled that, but for a single provision, SARFAESI was a constitutionally valid


214. This particular provision in question, Section 17(1)–(2), provides that

(1) Any person (including borrower), aggrieved by any of the measures referred to in sub-section (4) of section 13 taken by the secured creditor or his authorised officer under this Chapter, may prefer an appeal to the Debts Recovery Tribunal having jurisdiction in the matter within forty-five [days]. Of the claimed in the notice referred to in sub-section (2) of section 13 (2)

(2) Where an appeal is preferred by a borrower, such appeal shall not be entertained by the Debts Recovery Tribunal unless the borrower has deposited with the Debts Recovery Tribunal seventy-five per cent. of the amount claimed in the notice referred to in sub-section (2) of section 13: Provided that the Debts Recovery Tribunal may, for reasons to be recorded in writing, waive or reduce the amount to be deposited under this section.

SARFAESI §17(1)–(2).

The Supreme Court held that this particular remedy available under SARFAESI violated the right of equality, but otherwise held SARFAESI to be constitutionally valid. See Mardia Chems, 2 LRI at 2. This strengthened the rights of secured creditors and positioned them to be able to recover on defaulted loans by taking possession of the pledged security.
act, thereby paving the way for easier recovery of NPAs.\textsuperscript{215} However, challenges for securitizing NPAs go beyond the decision in \textit{Mardia Chemicals}. There are other systemic deficiencies in India that may derail the whole experimentation with securitization of NPAs.

Under existing law, asset reconstruction can be done by the creditors once a loan becomes non-performing, or by the ARC once it acquires the folio of NPAs from the creditors. However, as a practical matter, asset reconstruction is done by agencies separate from the banks upon acquiring the portfolio of such assets.\textsuperscript{216} This has created an issue of competency as to who is best able to recover on the debts owed to the banks.\textsuperscript{217} The loan sides of the banks that are most competent to understand the quality of these assets

\textsuperscript{215} The Supreme Court's judgment in \textit{Mardia Chemicals} led to the promulgation of the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Ordinance of 2004, which became an Act of Parliament on December 29, 2004, deemed effective retrospectively from November 11, 2004. See The Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2004, No. 30 [hereinafter Security Interest Amendment Act]. Under the Security Interest Amendment Act, a borrower may appeal a bank's actions before the DRTs without making the deposit as required originally under SARFAESI. Further, DRTs must dispose of any such appeal within sixty days of such application. \textit{Id.} § 10(b)(5). This period may be increased up to four months, at the discretion of DRT, provided the reasoning for such a decision is recorded in writing. \textit{Id.} If, however, the borrower is not satisfied with the DRT's disposition, it may appeal the DRT decision to the Appellate Tribunal by depositing "fifty per cent. [sic] of the amount of debt due from him, as claimed by secured creditors or determined by the Debts Recovery Tribunal, whichever is less: Provided also that the Appellate Tribunal may, for the reasons to be recorded in writing, reduce the amount to not less than twenty-five per cent.[sic] of debt . . . ." \textit{Id.} § 12(a)(iii). Ultimately the Security Interest Amendment Act has not dampened the intended effects of SARFAESI, and banks expect that a majority of defaulters will "return to the negotiating table," thereby making the process of extracting value from NPAs smoother. \textit{Supreme Court Arms the Securitisation Act}, Apr. 13, 2004, http://www.goodnewsindia.com/index.php/Supplement/articles/supreme-court-arms-the-securitisation-act/0/.


\textsuperscript{217} But see Background of Arcil, http://arcil.co.in/ARCIL/HOME/ASP/ARCIL_About.asp?MenuID=2&SubMenuID=14 (last visited Mar. 6, 2006) ("ARCs are established to acquire nonperforming assets (NPAs) from financial institutions and banks with the objective of focused management of these assets and maximization of recovery. Relieving institutions and banks of the burden of NPAs should allow them to focus on core activities.").
because of their experience in handling these loans since inception are removed from the process of reconstructing these assets. The treasury sides of the banks that buy these securities are traditionally not aware of the asset quality in these folios and remain dependant on risk models that may be far removed from reality.

There also exist several valuation issues while reconstructing NPAs in India. This is because in the Indian banking sector, provisioning requirements allowed the banks an almost indefinite time frame to carry such NPAs on their books. For one, this means that different banks provision differently for the same asset. For another, under SARFAESI, NPAs must be transferred to ARCs at market values. Because the amortization of losses that may occur upon transfer of such NPAs is not permitted and because current regulatory scheme does not compel the banks to transfer their NPAs, banks may be reluctant to do so.

Lack of secondary trading capability in the debt markets restricts active trading of the NPAs based asset-backed securities, leading to sub-optimal distribution of risks. This is because banks and financial institutions that have NPAs on their balance sheets are also doubling up as investors. Given the complexity of instruments backed by NPAs, such investments can be made only by Qualified Institutional Buyers. While the RBI has taken an active


219. See id.

220. RBI issues guidelines pursuant to SARFAESI to allow for transfer of assets to ARCs.

221. Although admittedly, this is more of a theoretical argument and its practical effects have not been visible so far. See, e.g., Indian Bad-Debt Buyer Awaits Foreign Funds, supra note 210 (“ARCIL paid $825 million for $3.7 billion worth of industrial bad loans from its main shareholder, ICICI Bank, State Bank of India and Industrial Development Bank of India. It hopes to nearly double its NPA book by March 2006.”).

222. Id. (“The banks and financial institutions are also doubling as investors,” he told Reuters, “We have got a buyer, we have got a seller, it so happens that the seller is the loan side of the same institution and the buyer is the treasury side.” (quoting Rajendra Kakker, Chief Executive Officer, Asset Reconstruction Company (India) Ltd.)).

223. Under SARFAESI,
role in realizing this constraint and is seeking to increase the number of potential buyers for such assets, the current regulatory regime does not facilitate such transactions for multiple reasons. For one, foreign institutional investment is still constrained. For another, although banks are permitted to buy and sell NPAs to other banks, such transactions must include cash consideration and can take place only after NPAs have been held by the banks for at least fifteen months. This implies that although the banks have at least two options to choose from when deciding which route to take to dispose of their NPAs, one option is significantly less attractive from the buyers' perspective. Further, because of the requirement that NPAs be classified as such for at least two years, it

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‘Qualified Institutional Buyer’ means a financial institution, insurance company, bank, state financial corporation, state industrial development corporation, trustee or any asset management company making investment on behalf of mutual fund or provident fund or gratuity fund or pension fund or a foreign institutional investor registered under the Securities and Exchange Board of India Act, 1992 or regulations made thereunder, or any other body corporate as may be specified by the Board. § 2(1)(u).

224. RBI issued new guidelines in July 2005 permitting banks to sell their folios of NPAs to other financial entities, including banks, financial institutions, and non-banking financial institutions, operating in India. See RESERVE BANK OF INDIA, REPORT ON TREND AND PROGRESS OF BANKING IN INDIA, 2004-2005.

225. See Price Waterhouse Coopers, NPL Asia, Nov. 2005, at 2 (explaining that competition among foreign banks with licensed banking operations in India for buying folios of NPAs is “somewhat limited pending foreign investment liberalization”).

226. Id. (explaining RBI guidelines of July 2005).

227. Id.

228. July 2005 RBI guidelines provide that, among other things,

1. Loans must be classified as NPLs for at least 2 years
2. Consideration must be in cash
3. NPLs cannot be resold by the buyer before 15 months
4. If purchased by a bank, the NPLs will be treated as standard assets in the bank’s books for 90 days, after which asset classification would depend on recovery with reference to the cash flows estimated.

Id. Therefore, a buyer must provide cash for acquiring the folio of NPAs, making it a drain on the buyer’s capital reserves.

229. Id.
increases the costs to the banks because of the provisioning requirements.\textsuperscript{230}

**CONCLUSION**

In shaping its most comprehensive response to date to the problem of NPAs in the form of securitization legislation, India has taken a well-trodden path.\textsuperscript{231} While Indian experimentation in enhancing creditors' rights, and thereby creating an environment for developing an asset-backed securities market based on NPAs has potential problems, it has given two important results. First, it has boosted banks' health,\textsuperscript{232} and secondly, it has helped, if only

\textsuperscript{230} The current guidelines provided by the RBI, purchasing banks must ensure compliance with prudential credit exposure ceilings. See **Reserve Bank of India**, supra note 224, at 36.


\textsuperscript{232} Various government reports indicate that SARFAESI has had positive effect on reducing the amount of NPAs in the Indian banking sector. Consider this:

The decline in NPAs has also been evidenced across bank groups, except in 2000-01. In line with this declining trend, NPAs declined sharply in 2002-03, reflecting, inter alia, the salutary effect of earlier measures towards NPA reduction and the enactment of the SARFAESI Act ensuring prompter recovery without intervention of court or tribunal. The progress under this Act has been significant, as evidenced by the fact that during 2002-03, reductions outpaced addition, especially for PSBs and reflected in an overall reduction of non-performing loans to 9.4 per cent of gross advances from 14.0 per cent in 1999-2000.

R. Umarji, *Trends and Developments in Insolvency Systems and Risk Management: The Experience of India*, in **Forum on Asian Insolvency Reform**
in a miniscule way, in the development of a stronger debt market,\(^{233}\) which is necessary to provide the “spare tire” for the economy.\(^{234}\) Therefore, Indian policy makers have given a strong impetus to the long term health of its economy by venturing in the direction of removing the reliance of its fast growing economy on bank lending. In addition, as the health of the banking sector improves, increased availability of credit should boost investments and economic vitality. Under these circumstances, perhaps the Indian response, even if it is an elephant’s tale, is best described as such because of its comprehensiveness, amounting to majesty and grace, rather than inertia on the part of Indian policymakers.

\(^{233}\) This experiment, in many ways, is similar to the model used by Hong Kong in creating a secondary debt market by securitizing mortgages. See Stefan Gannon, *The Use of Securitization to Mobilize Liquidity and in Particular the Use of Specialized Mortgage Corporations*, in *INTERNATIONAL BANK INSOLVENCIES: A CENTRAL BANK PERSPECTIVE* 301, 304-09 (Mario Giovanoli & Gregor Heinrich eds., 1999). Of course, there is a bit of chicken-and-egg problem when we talk about securitization and how it can help boost the development of a local bond market. This is because, although securitization provides an incentive to develop local bond markets, securitization itself requires a local bond market so that assets can be priced accurately. See Jabre, *supra* note 15, at 51 (“[S]ecuritization provides an incentive to developing local bond markets because securitized assets cannot be evaluated and priced without a liquid “plain vanilla” asset in the market. “Plain vanilla” assets are straight bonds characterized by bullet payments, fixed coupons, and, in contrast to securitized assets, single obligors with clean credit structures and payment structures. Once a market for plain vanilla securities is in place, it is possible to build complex markets such as securitization on top of it.”).