# FACILITATING THE ADOPTION OF REGULATORY IMPACT ASSESSMENT IN INDIA

## Consolidated Project Report: Regulatory Impact Assessment in Indian Financial Sector

CUTS International

# PART I

# Regulatory Impact Assessment in Indian Banking Sector: Improving Debt Recovery

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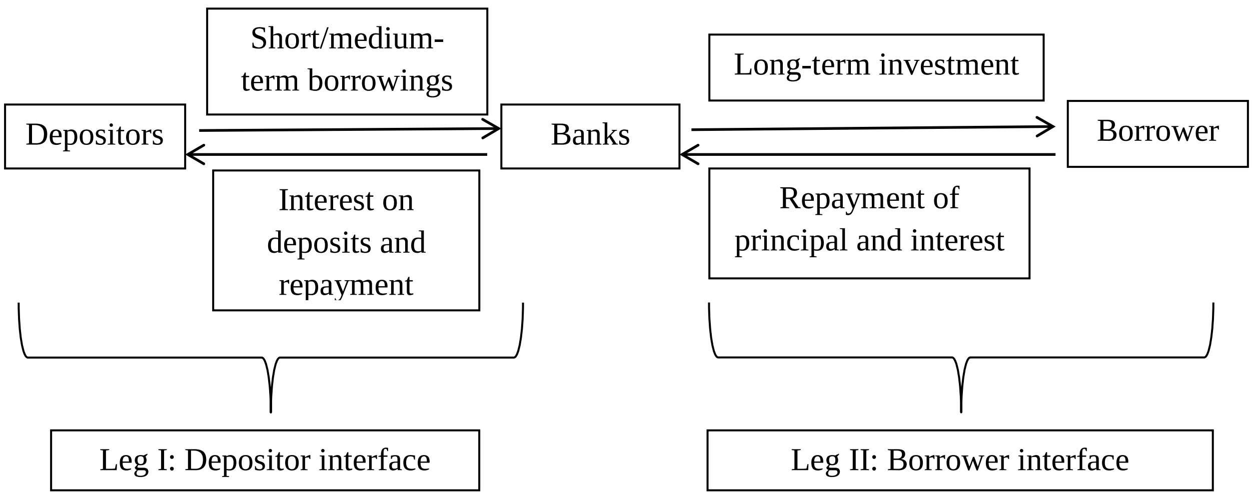
# *Chapter 1*
# Need for RIA in Indian Banking Sector

## 1. Role of Banks in an Economy

Indian financial sector comprises several laws and regulations governing its different segments viz. banking, insurance, payments, securities and capital markets *et al*. Studies indicate that over 60 primary laws regulate financial sector, which the government is in the process of rationalising.[1] Banking comprises a significant part of Indian financial sector and with reach across the length and breadth of the country, from poor to the rich and has gained humungous size. Financial intermediaries[2] like banks perform necessary asset transformation function in an economy. Asset transformation is the process of creating a new asset (loan) from liabilities (deposits) with different characteristics by converting small denomination, immediately available and relatively risk free bank deposits into loans – relatively risky, large denomination asset – that are repaid following a set schedule.[3]

The cycle of asset transformation is complete when the banks receive promised and timely returns from risky assets to repay their liabilities and they earn margins in the process. See Figure 1.1 for diagrammatic representation.

**Figure 1.1: Asset Transformation Function of Banks**




## 2. Weaknesses in Borrower Interface in India

A successful asset transformation is dependent on efficient conduct of depositor and borrower interface by banks. While Indian banks have been successfully conducting borrower interface

[1] Report of the Financial Sector Legislative Reforms Commissions, 2013, available at: *http://finmin.nic.in/fslrc/fslrc_report_vol1.pdf*
[2] "*Financial intermediation is the process bringing together those who need financing, such as businesses and governments, with those who provide financing, such as lenders depositors and private investors, and facilitating the flow of capital between them*", Global Association of Risk Professionals, 2009.
[3] Key concept definitions, Global Association of Risk Professionals, 2009. For instance, banks collect deposits worth₹1 lakh from different small depositors and provide long-term loan to power production companies.

functions in the past and have kept their 'NPAs[4] under check, the efficiency in this function has seen diminution lately.

While the Gross NPA (GNPA)[5] ratio (as a percentage of gross advances) of SCBs declined steadily from 15.70 percent at end March 1997 to 2.35 percent at end March 2011, it spiked to 4.11 percent at the end of March 2014. In addition, the 'restructured but standard loans' (as a percent of gross advances) increased considerably from 1.14 percent in March 2008 to 5.87 percent in March 2014. Further deterioration in asset quality was recorded during April 2014 to March 2015 period wherein the GNPA ratio and restructured advances ratio increased to 4.45 percent and 6.45 percent respectively at the end of March 2015. As such, the overall stressed advances[6] have remained high with considerable increase in the recent period to 10.90 percent for the banking system as at the end of March 2015. The level of distress is not uniform across the bank groups. It is more pronounced in respect of PSBs. The Gross NPAs for PSBs as on March 2015 stood at 5.17 percent while the stressed assets ratio stood at 13.2 percent, which is nearly 230 bps more than that for the system.[7]

This indicates to the increasingly deteriorating quality of the borrower interface function, required to successfully run asset transformation business by banks.

## 3. Fixing Accountability of Borrowers

When borrowers default on loans, the lenders typically re-negotiate the contract. If renegotiation fails then they sell the pledged collateral to recover their money. Alternatively, the lenders resort to various legal forums or extra-judicial measures, available for recovery of debt due.[8]

To enforce repayments and recovery of debts, banks could approach *Lok Adalats* or DRTs, or invoke the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act).[9]

Over the years, the percentage of debt recovered through these modes has steadily decreased. See Table 1.1 for details.

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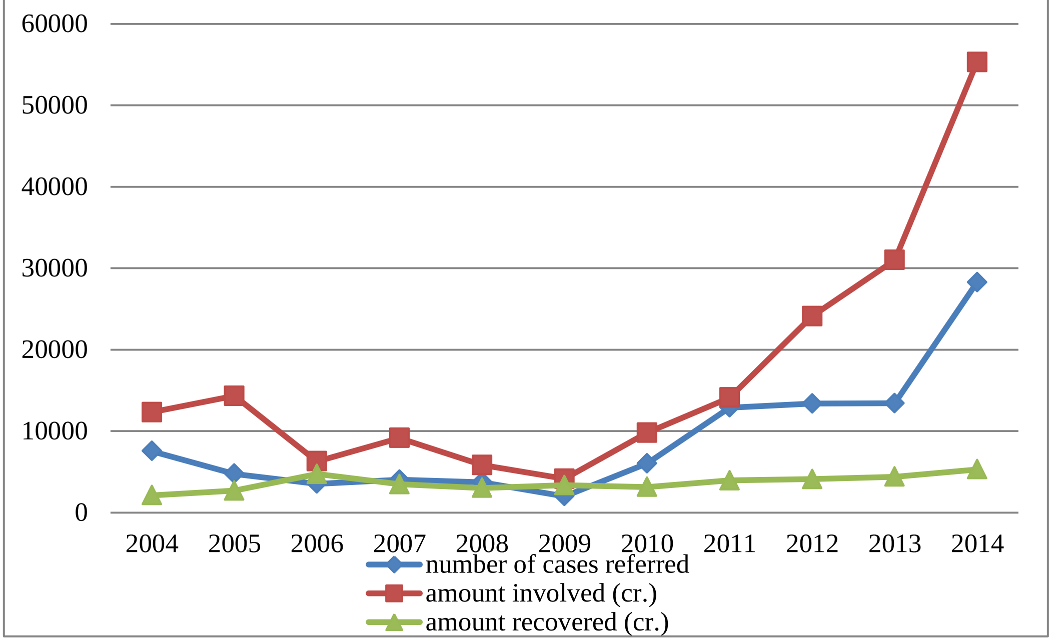
[4] An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank (RBI Glossary). A loan is termed as non-performing when the amount due is not repaid within a specified period (as determined according to RBI regulations) after the due date.
[5] Gross NPA=Net NPA + (Balance in Interest Suspense account + DICGC/ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held).
[6] (NPAs + Restructured advances).
[7] Lecture delivered by S S Mundra, Deputy Governor, RBI, at Bangalore as a part of the Memorial Lecture series launched by State Bank of Mysore in the memory of His Highness Sri Nalwadi Krishnaraja Wadiyar on April 29, 2015, available at: *https://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=955*, last visited on May 01, 2015.
[8] Financial Sector Legislative Reforms Commission Working Group on Banking (2013).
[9] In addition to approaching civil courts.

| Table 1.1: Trend in Debt Recovery | |
|---|---|
| **Year** | **Percentage of amount recovered**[10] |
| 2010 | 24.02 |
| 2011 | 31.40 |
| 2012 | 23.07 |
| 2013 | 21.90 |
| 2014 | 18.00 |
| *Source: Statistical tables relating to banks in India, RBI* | |

While the percentage of amount recovered has steadily decreased, the number of matters referred and the value of amount involved has increased significantly over the years. As is evident from **Figure 1.2**, while the number of cases and the amount involved in the cases referred at DRTs has increased significantly, no considerable increase can be observed in the amount recovered.

**Figure 1.2. Trends in Debt Recovery from DRTs**




*Source: Statistical Tables Relating to Banks in India, Table 19: NPAs of scheduled commercial banks recovered through various channels, December 2014*

In absolute terms, the total number of matters referred under various mechanisms of debt recovery during fiscal 2014 was around 1.86mn, involving amount of around ₹1,731bn. The total amount recovered during fiscal 2014 was meagre amount of ₹311bn.

[10] Percentage of amount recovered during a year to total amount involved. However, the amount recovered during the given year could be with reference to cases referred during the given year as well as during the earlier years.

As the process of possessing and selling collateral or legal enforcement of debt contract becomes more difficult, it adds friction to debt markets that impede the efficiency of the market.[11] Delay in recovery or under-recovery of due amount is not merely a problem between contracting parties, i.e. a lender/bank and borrower. Entwined with this contract is the general welfare of the public, out of whose deposits the bank loan has been granted (as indicated in Figure 1.1).

On account of delay in recovery, while the banks lose an opportunity to earn income in alternative investments, the security and collateral might also lose value and hence banks might incur capital loss as well. More importantly, the delays in recovery proceeds can lead to liquidity crisis in the bank, run on the bank and consequent failure of the bank. From the society's angle, the productive assets are held up, not producing value, and not creating employment and income. From the government's perspective, if such loan losses cascade and turn into systemic risk and endanger the financial and economic stability, the tax payers' money will have to be used up for rescuing these banks, otherwise the depositors, meaning the ordinary, general public will have to bear losses. Thus from many perspectives, timely recovery of loans are critical for the borrower, the bank, the society and the government.[12] In order to prevent the problem of low and slow debt recovery escalate to such levels, immediate long-term fixes for such regulatory failure need to be developed.

The banking sector suffers with other infirmities as well, such as limited competition,[13] high entry barriers, differential treatment of PSBs, product based regulation and limited consumer protection. However, as indicated above, the problem of the low and slow debt recovery, if not immediately addressed has the potential to achieve systemic proportions. Consequently, this study focuses on the problems of debt recovery.

## 4. Regulatory Impact Assessment

In order to correctly understand the causes of regulatory failure in the area of debt recovery, a systematic approach is required. Critical legislations in-place will have to be analysed to identify sub-optimal provisions or issues, which remain unaddressed in such legislations. Thereafter, legislative alternatives to the identified provisions will have to be designed to fix the problem of low and slow debt recovery. In order to avoid repetition of regulatory mistakes, it must be ensured that the costs imposed by the proposed regulatory changes will be outweighed by the benefits and concerns of the stakeholders should be taken into account. The cost-benefit analysis must be a means to achieve the end of good regulation.

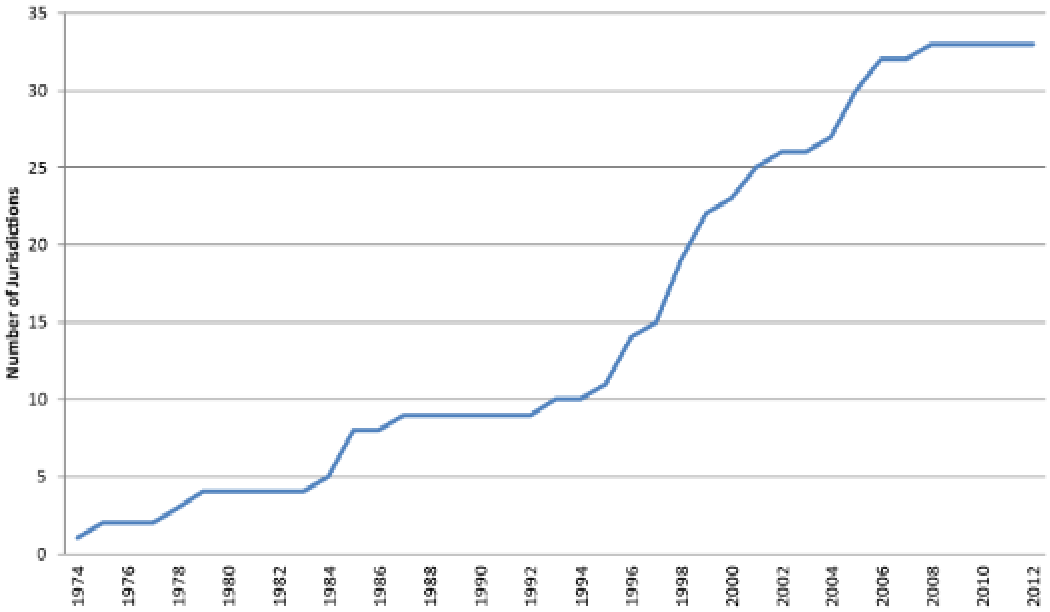
One of the systemic approaches to critically assess the positive and negative effects of regulatory proposals and existing regulations/legislations/policies is RIA. It is an important element of an evidence-based approach to policy-making, as it essentially comprises stakeholder engagement in policy-making and review. RIA aids in devising optimal regulatory interventions to alter natural state of market to achieve desired objectives. As regulatory interventions change behaviour of the stakeholders and thus impose additional costs on them, it helps in designing most justifiable regulatory intervention, benefits of which can outweigh their costs. Analysis shows that conducting RIA within an appropriate

[11] Supra note 12.
[12] R Gandhi, *Banks, Debt Recovery, and Regulations: A synergy*, RBI Bulletin, February 10, 2015.
[13] It should be noted that with the recent grant of licenses to new banks in India, the number of players in banking sector is expected to increase.

systematic framework can underpin the capacity of governments to ensure that regulations are efficient and effective in a changing and complex world.[14]

Figure 1.3 shows the trend in adoption of RIA by various Organisations for Economic Cooperation and Development (OECD) jurisdictions.[15]

**Figure 1.3: Trend in Adoption of RIA in OECD Countries**




**Note:** this represents the trend in the number of countries with a formal requirement for regulatory impact analysis (beyond a simple budget or fiscal impact).

Non-OECD countries are increasingly realising the benefits of RIA. Some of the non-OECD countries have started experimenting with RIA.[16] Experts have recommended adopting RIA for emerging economies including India.[17]

RIAs are implemented during development as well as review/amendment of policies/ legislations/ regulations. It essentially involve stakeholder consultations in a structured manner and thus aid in adoption and implementation of regulatory prescriptions. In addition,

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[14] OECD, Regulatory Impact Analysis, available at: *http://www.oecd.org/gov/regulatory-policy/ria.htm*
[15] Source: OECD (2012), available at: *http://www.oecd.org/gov/regulatory-policy/ria.htm*
[16] Such as South-Africa, South Korea.
[17] The Report of the Working Group on Business Regulatory Framework (Planning Commission, 2011) notes, "*It is recommended that RIA has to be adopted for improving the quality of business regulatory governance in India. RIA will help with the identification of unreasonable burdens on business and in devising ways through, which such burdens are kept to a minimum, if not eliminated altogether. Because RIA includes consultation with a wide range of stakeholders, it also provides ample opportunity to bring up unforeseen consequences or real life experiences for consideration while weighing and measuring the impact of any regulation or policy. It thus increases the accountability of the whole regulatory governance process.*" The Report of the Financial Sector Legislative Reforms Commission (2013) recommends adoption of cost-benefit analysis in regulation making and review. The Damodaran Committee Report (2013) and the Tax Administration Reforms Commission also recommends adoption of RIA in India.

RIAs ensure clarity in objectives putting in place appropriate tools/powers to achieve the objectives, and adequate accountability mechanism to prevent misuse of powers/tools.

Figure 1.4 sets out the process of undertaking RIA.

**Figure 1.4: Process of Conducting RIA**

**Problem definition**

- The first and the most critical step in any RIA is defining the problem. Problem definition sets out the objective and scope of RIA exercise and stakeholders involved.

**Evaluating the baseline**

- This involves identification of issues, understanding the costs and benefits of the as-is/prevailing scenario by stakeholder interaction, in-depth literature review and analysis of relevant regulatory provisions/ proposals.

**Developing alternatives**

- Multiple alternatives intending to achieve desired change in the baseline scenario are developed. The Alternatives could be no-regulation, co-regulation, direct regulation, etc. Costs and benefits of the alternatives are estimated.

**Comparing and selection**

- The alternatives are compared *inter-se* and with the baseline scenario using various tools, such as the cost-benefit analysis, cost-effective analysis, multi-criteria analysis etc, for selection of the alternative having the potential to result in greatest net benefit.

While this chapter defines the problem of low and delayed debt recovery and sets the stage for conducting RIA in banking sector, the subsequent chapters delve and implement in detail, the next steps of RIA.

In the following chapters, two primary legislations significantly impacting debt recovery by banks in India will be selected and an in-depth RIA on such legislations will be conducted. The intention is to keep the project focused and thus select two legislations for conducting RIA. The RIA will conclude with suggesting legislative alternatives to select provisions of the identified legislations, on the basis of comparison of costs and benefits of the baseline scenario and different alternatives.

# Chapter 2:
# Selection of Legislations

## 1. Background

More than a dozen primary and secondary legislations[18] have been enacted in connection with the banking sector in India, which have laid a firm foundation of this pivotal sector. However, the genesis of many of them can be traced back to more than half a century, and even prior to adoption of the Constitution. As a result, these laws like the Reserve Bank of India Act, 1934; the Banking Regulation Act, 1949; the State Bank of India Act, 1955; the State Bank of India (Subsidiary Banks) Act, 1959, etc. have been amended from time to time to keep pace with the changing realities. However, their legal foundations remained more or less static with serious fractures in the system in the form of lack of clarity on responsibility and powers of regulators[19], inter-regulatory disputes, growing shadow banking in financial sector and constantly changing needs of market participants. This has led to a framework which is complex, sub-optimal, ambiguous, inconsistent and open to regulatory arbitrage.[20]

It seems that taking advantages of the loopholes in the old banking laws, the PSBs were not agile enough to prevent accumulation of a large volume of NPAs.[21] As discussed in previous chapter, the problem of low recovery of debts due to banks and financial institutions is further adding difficulties for the banking sector and consequently, the economy also. As evidenced by the 1991 and 2008 financial crises, performance of banks impacts not only the financial sector but the economy as a whole, including taxpayers and the society. Therefore, there is a need to ensure that the banking sector: (i) is cautious in making lending decisions (ii) recognises financial distress early (iii) takes prompt corrective action and (iv) is able to speedily recover the outstanding amount.

As discussed earlier, the scope of this study is limited to debt recovery. Laying down of rigorous provisions in the law and ensuring their strict enforcement to facilitate quicker recovery of debts could benefit the entire banking fraternity and the overall economy.

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[18] Primary legislation is a main law passed by the legislative branch of government. In contrast, secondary legislation is a subordinate law /delegated legislation made by the executive branch within the boundaries laid down by the legislature.

[19] Principal legislation governing the NBFCs is the Reserve Bank of India Act, 1934 (RBI Act). However, certain categories of NBFCs are under supervision of other regulators such as Housing finance companies are regulated by National Housing Bank (NHB); merchant banker, venture capital fund, stock brokers, etc. by the Securities and Exchange Board of India (SEBI) and insurance companies by the Insurance Regulatory and Development Authority of India (IRDA). Similarly, Chit Fund Companies are regulated by the respective state governments and Nidhi Companies by the Ministry of Corporate Affairs (MCA). As a result, products issued by various NBFCs are regulated differently, resulting in market to be subjected to loose regulations.

[20] Supra note 5.

[21] See Dr Pradip Kumar Biswas and Ashis Taru Deb, *'Determinants of NPAs in the Indian Public Sector Banks: A Critique of Policy Reform'*, available at: www.igidr.ac.in/money/mfc-13/mfc_6/mfc_06/biswasdeb.doc, *last visited on February 03, 2015.*

This chapter discusses in brief relevant primary legislations[22] that deal with the issue of debt recovery in India. This is followed by a comparison of such legislations based on certain indicators and vetting by subject experts for selection of two legislations for the purpose of undertaking RIA. The primary legislations (accompanied by respective rules issued by the Central Government from time to time) in relation to the issue of debt recovery include:

- Sick Industrial Companies (Special Provisions) Act, 1985 (SICA)
- Legal Services Authorities Act, 1987
- Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT Act)
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act/Securitisation Act) and
- Companies Act, 2013 (the 2013 Act) – Chapter XIX - Revival and Rehabilitation of Sick Companies.

As highlighted earlier, the study aims to undertake RIA of primary legislations only. Accordingly, review of the secondary laws is outside the ambit of the study. However, with a view to demonstrate a comprehensive debt recovery framework, outlined below are certain draft/existing relevant regulations, guidelines and circulars pertaining to debt recovery issued by the RBI.

- Master Circular on 'Prudential norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'
- Discussion Paper on 'Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy'
- Prudential Guidelines on Restructuring of Advances by Banks and Financial Institution,
- Guidelines for Compromise Settlement of Dues of Banks and FIs through *Lok Adalats*
- Guidelines on Restructuring of Advances by NBFCs
- Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP) and
- Master Circular on 'Wilful Defaulters', etc.

Also, the capital markets regulator, Securities and Exchange Board of India (SEBI) has recently issued a Discussion Paper on 'wilful defaulter' with a view to impose restrictions on wilful defaulters from accessing the capital market. The objective of imposing the restrictions is to limit the ways wilful defaulters can raise money, and avoiding any possibility of such money, remaining unrealised in future as well.

[22] Scope of the project envisaged undertaking RIA on the primary financial sector laws only since much focus has already been given on RIA of secondary regulations, but not much work has been done in relation to primary legislations.

## 2. Brief Description of Key Legislations

This section provides a brief description of key banking primary legislations dealing with the issue of debt recovery in India.

### *2.1. The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA)*[23]

In line with the recommendations of the T Tiwari Committee[24],the Central Government enacted a special legislation namely the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) with the objective of reviving sick industrial companies. It was expected that upon turnaround, such companies would have been in a position to repay borrowed amount and thus facilitating in debt recovery.

SICA[25] provides for an automatic stay/suspension of all kinds of recovery and distressed proceedings (including debt recovery), once the reference filed by the company is registered in the Board for Industrial and Financial Reconstruction (BIFR). This could act as a huge impediment in debt recovery as the aforesaid provision could lead the BIFR to become a safe haven for defaulting companies. The companies could easily file reference with the BIFR, sometimes by manipulating their accounts to reflect net worth erosion resulting in attracting this immunity against the recovery action by the creditors.[26]

Further, SICA is predominantly a remedial and ameliorative law so far as it empowered the quasi-judicial body (BIFR) to make appropriate measures for revival and rehabilitation of potentially viable sick industrial companies. This includes provision of financial assistance by way of loans, advances or guarantees from the government, any scheduled bank or any other bank and public financial institution or any other authority[27]. This provision might be prejudicial to the asset quality of the banks/financial institutions as such financial assistance might not be adequately secured, and increase the exposure of banks /financial institutions to relevant sick industrial company.

Consequently, as often happens with many such laudable measures, there was a wide gap between the aim and performance under SICA. Though the BIFR was set up to deal with revival and rehabilitation of sick industrial companies, in reality the whole process became very slow and painful for all the genuine stakeholders, including the lenders, and this lengthy process, lack of timely commencement of proceedings and poor enforcement mechanism defeated the basic purpose of SICA.[28]

### *2.2. The Legal Services Authorities Act, 1987 (the LSA Act)*

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[23]SICA, 1985 was repealed and replaced by the Sick Industrial Companies (Special Provisions) Repeal Act, 2003. Under this, BIFR and AAIFR (Appellate Authority for Industrial and Financial Reconstruction) was dissolved, and replaced by the National Company Law Tribunal (NCLT) and National Company Law Appellate Tribunal (NCLAT) respectively. However, legal hurdles prevented the NCLT and NCLAT from being constituted and accordingly, the 2003 Act is yet to be made effective.

[24]The Committeewas set up to examine the legal and other problems faced by the banks and financial institutions in rehabilitation of sick industrial units, and to suggest remedial measures for effective tackling the problem of industrial sickness.

[25]Section 22 of SICA, 1985.

[26] *'Emerging Insolvency in India: Issues and Options',* available at: *http://iica.in/images/confdetailpaper/Country_Report_on_Corporate_Insolvency_laws.pdf*, last visited on February 04, 2015.

[27]Section 19 of SICA, 1985.

[28] See, *Pavan Kumar Vijay, "Revival & Rehabilitation of Sick Companies – A Paradigm Shift"*, available at: *http://cpadvocates.in/Dynamicimages/260_1_843634656122018437500.pdf*, last visited on January 15, 2015

The LSA Act was enacted in the year 1987 to provide a statutory base to legal aid programmes throughout the country on a uniform pattern. *Lok Adalats* (formed and given statutory status under the LSA Act[29]) are one of the important forums where disputes/cases (including matters relating to debt recovery) pending at various courts or even at pre-litigation stage are settled amicably. Under the LSA Act, the *Lok Adalats* are vested with the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying a suit. Every award of *Lok Adalat* is deemed to be a decree of a civil court and no appeal is possible to any court against the award made by *Lok Adalat*.[30]

*Lok Adalats* help banks to settle disputes involving account in a 'sub-standard'[31], 'doubtful'[32] and 'loss'[33] category with outstanding balance of ₹2mn or more[34]. Interestingly, about 88 percent of cases relating to debt recovery are referred to *Lok Adalats*[35] as these help in resolving disputes between the parties by conciliation, mediation and compromise, and ensure amicable settlement. However, despite being such a popular method, banks find difficulty in bringing the parties together when *Lok Adalat* meets.[36] Consequently, this channel of debt recovery has not proven to be effective *vis-à-vis* other channels like DRTs, measures under SARFAESI Act, etc. The recovery using this channel is merely around 4.50 percent of the total recovery of debts (₹311bn) during the financial year 2013-14[37].

### *2.3 The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDBFI Act/ DRT Act)*

The Recovery of Debts Due to Banks and Financial Institutions Act, 1993, (DRT Act) came into force on June 24, 1993[38]. It allowed the Central Government to establish DRTs and DRATs (together with DRTs referred as RTs) to help banks and financial institutions in recovering their dues speedily without being subjected to the lengthy procedures of civil courts.

The recovery tribunals (RTs i.e. DRTs and DRATs) were set up as quasi-judicial institutions to deal exclusively with the debt recovery cases. They are quasi-judicial in the sense that they were established by the executive arm of the government and fall under the purview of the

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29 Chapter VI of the Legal Services Authorities Act, 1987.

30 Section 21 of the Legal Services Authorities Act, 1987.

31 A sub-standard asset is one, which has remained NPA for a period less than or equal to 12 months.

32 An asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months or more.

33 A loss asset is one which has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.

34 Guidelines for Compromise Settlement of Dues of Banks & FIs through *Lok Adalats*, issued by the RBI, available at: *http://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=1813*, last visited on January 15, 2015

35 The Statistical Tables relating to Banks in India, published by the RBI, available at: *http://dbie.rbi.org.in/OpenDocument/opendoc/openDocument.jsp*, last visited on January 15, 2015

36 See, K K Siraj and Prof (Dr) P Sundarsanan Pillai, *'Management of NPAs in Indian SCBs: Effectiveness of SARFAESI Act, DRT and Lok Adalat during 2004-2011',* International Journal of Business and Management Tomorrow (Vol.2, No. 4)

37 The Statistical Tables relating to Banks in India, published by the RBI, available at: *http://dbie.rbi.org.in/OpenDocument/opendoc/openDocument.jsp*, last visited on January 15, 2015

38 About 15 lakh cases pertaining to debt recovery were pending at various civil courts in India as on September 30, 1990. The amount stuck in litigation amounted to ₹5,622 crore pertaining to PSBs and ₹391 crore pertaining to FIs. This forced the government to set up the Narasimhan Committee in 1991 to study the possibilities of a revamp this situation. It, among other recommendations, endorsed the proposal of the T Tiwari Committee regarding the establishment of DRTs for the recovery of debts, leading the government to pass the DRT Act.

Ministry of Finance unlike civil and criminal courts, which are part of the judiciary (under the ambit of the Ministry of Law & Justice).

Studies have shown that the RTs have reduced the time taken to process the debt recovery cases, and simultaneously reduced delinquency by 3 to 11 percent in loan repayment as these were set up as special purpose tribunals to deal with debt recovery matters only.[39] The amount recovered from cases (including cases related to earlier years) decided in 2013-14 by RTs was around ₹30,590 crore, which is merely about 13 percent of the total amount at stake, that is, ₹2,36,600 crore[40]. Given this substantially low recovery under the DRT mode, it seems that the DRT Act have certain sub-optimal provisions and implementation bottlenecks that impede speedy debt recovery.

### *2.4. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act/Securitisation Act)*

To make the debt recovery swifter, the government passed the SARFAESI Act, 2002 (commonly known as the Securitisation Act).[41] This was intended to enable banks and financial institutions enforce their security interest without having to resort to courts and tribunals, so that debts could be recovered speedily. The Securitisation Act allowed banks and financial institutions to take possession of the collateral security offered by the defaulting borrowers and sell these assets without having to go through protracted legal procedures.

The total amount recovered (including cases related to earlier years) is merely around 26 percent of the total outstanding amount under the SARFAESI mode during the financial year 2013-14[42]. Considering this low recovery, SARFAESI Act also seems to have certain sub-optimal provisions, having the potential to delay the debt recovery.

Furthermore, it is noteworthy that SARFAESI Act has an overriding effect on the SICA,[43] and Chapter XIX of the Companies Act, 2013[44]. This means any reference made or to be made to the BIFR (under SICA) and NCLT (under Companies Act, 2013) stands abated, once the secured creditor has taken any measure[45] or the securitisation/reconstruction company has taken over any financial asset[46] under the provisions of the Securitisation Act.

### *2.5. The Companies Act, 2013 (the 2013 Act)*

The Companies Act, 2013 (the 2013 Act)[47] lays down the provisions for 'Revival and Rehabilitation of Sick Companies'. While the coverage of the SICA was limited only to industrial companies, the 2013 Act covers the revival and rehabilitation of all companies

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[39] See Sujata Visaria (Boston University), *"Legal Reform and Loan Repayment: The Microeconomic Impact of Debt Recovery Tribunals in India"*, April, 2006.

[40] Talk by Dr Raghuram G Rajan at the Third Dr Verghese Kurien Memorial Lecture at IRMA, Anand on November 25, 2014, available at: *http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/SCR251114VER3RD.pdf*, last visited on January 15, 2015.

[41] Realising the gravity of the low debt recovery crises in the banking sector, the government was quick to implement the recommendations of the Narsimham Committee – II and Andhuarjuna Committee leading to the enactment of the SARFAESI Act, 2002.

[42] The Statistical Tables relating to Banks in India, published by the RBI, available at *http://dbie.rbi.org.in/OpenDocument/opendoc/openDocument.jsp*, last visited on January 15, 2015

[43] Section 15 of the SICA, 1985.

[44] Section 254 of the Companies Act, 2013.

[45] As specified under Section 13(4) of the SARFAESI Act.

[46] Under Section 5 of the SARFAESI Act.

[47] Chapter XIX of the Companies Act, 2013 (relating to Revival and Rehabilitation of Sick Companies).

irrespective of their sector. On revival of sick companies, they would have been in a position to repay borrowed amount and thus facilitating in debt recovery.

In relation to determination of sickness of a company, it would no longer be based on a situation where accumulated losses exceed net worth (as mandated under the SICA, 1985), but on the basis whether the company is able to pay its debts. In other words, the determining factor of a sick company has been shifted to the secured creditors and/or banks and financial institutions with regard to assessment of a company as a sick company[48].

Further, once the application is made by the applicant company under the provisions of the 2013 Act, no suit for the recovery of any money or for the enforcement of any security against the company shall lie or be proceeded with[49]. Accordingly, the 2013 Act supersedes the proceedings under the DRT Act. However, such stay would be operative for 120 days only[50].

The aforesaid legislations directly or indirectly deal with the issue of debt recovery. While procedure relating to revival and rehabilitation of sick companies is governed by the SICA and Companies Act, 2013, the DRT Act provides for setting up of special tribunals to facilitate speedy adjudication of debt recovery cases and swift execution of verdicts. Taking a step further, the SARFAESI Act was enacted to empower the secured creditors to foreclose non-performing loans by enforcing the security interest without going through a lengthy judicial and tribunal process. The Securitisation Act also provides for setting up of Securitisation Companies/Reconstruction Companies (SC/RC), which would acquire the non-performing loans from secured creditors by issue of Security Receipts. Whereas, the Legal Services Authorities Act, 1987 provides for establishment of *Lok Adalats*, which help in resolving disputes by conciliation, mediation and compromise, and ensures amicable settlement.

## 3. Selection of legislation for regulatory impact assessment

### *3.1. Indicators for comparison*

A bank loan is not just a contract between the bank and the borrower. Entwined with this contract is the general welfare of the public, out of whose deposits the bank loan has been granted. Timely recovery of bank loans is important for the economy as a whole including the secured creditor, the society, the government and the borrower as well. In this regard, SICA, 1985, Legal Services Authorities Act, 1987, DRT Act, 1993, SARFAESI Act, 2002 and Companies Act, 2013 are the most crucial primary legislations. Banks and financial institutions restore to one or more of aforesaid modes to recover their outstanding debts.

The research project envisages assessing impact (costs and benefits) of provisions of primary legislations in the banking sector. Relevant primary legislations (as discussed in the previous section) relating to debt recovery have been identified post literature review and interaction

[48]In accordance with the provisions of the Section 253 of the 2013 Act, a company is assessed to be a sick company, if the company is unable to pay or secure or compound the payment on demand by its secured creditors representing 50 percent or more of its outstanding debts.
[49]Section 253(2) of the 2013 Act.
[50]Section 253(3) of the 2013 Act.

with several sector experts, including the national reference group (NRG) for the project[51]. In order to select most relevant primary legislations amongst these for conduct of RIA, apparent burden of these legislations needs to be assessed and compared, and those legislations must be selected for conduct of RIA, which have the potential to impose maximum costs on concerned stakeholders. This approach was also ratified during the stakeholders' consultation undertaken as a part of the project.

Literature on assessment and comparison of cost of doing business suggests comparison of relevant legislations on the basis of three broad indicators, viz. time, costs and recovery rate.[52] Time includes average time taken until the actual payment of some or all of the money owed to the bank is made. Potential delay tactics by the parties, such as the filing of dilatory appeals or requests for extension, are considered. Costs include court fees, fees paid to the lawyers, insolvency administrators, auctioneers and assessors, and all other fees and costs. The recovery rate is the proportion of amount recouped by secured creditors through reorganisation, liquidation or debt enforcement proceedings.

On this basis, and upon suitable modification in discussion with subject experts, following indicators were developed for the purpose of comparison of selected legislations:

- **Time**: Statutory time period within which the order is required to be passed by the respective authorities.
- **Procedures**: Authorities involved in the proceedings. As number of authorities in the debt recovery process also indicates the complication in the procedures involved, this indicator has been added.
- **Costs**: Fees paid to the lawyers, insolvency administrators, auctioneers and assessors, court fees and facilitation payments.
- **Focus on debt recovery**: Legislations exclusively framed for dealing with the problem of debt recovery. As focus of the study is debt recovery, this indicator has been added.
- **Legislations in force/evidence of implementation**: Relevance of legislations for undertaking RIA, and existence of evidence of implementation is necessary to conduct RIA. Consequently, this indicator has been added.

### *3.2. Comparison of legislations*

On the basis of indicators developed above, the comparison of various primary legislations (as discussed in section 2 of this chapter) is set out in Table 2.2. For ease of comparison, each of the indicators has been assigned weights ranging from 1 to 3 points. The weights increase with the perceived cumbersomeness of provisions of the legislations, i.e., more cumbersome/burdensome the provision, the higher the weights and vice-versa. The two legislations with highest weights would be potentially be most cumbersome, and consequently would be selected for the purpose of study.

**Table 2.1** shows the basis on which weights are assigned to indicators.

**Table 2.1: Table of Weights**

[51] Details about the project advisory committee are available at: *http://www.cuts-ccier.org/BHC-RIA/pdf/NRG-Members.pdf*.

[52] World Bank, *Doing Business: Measuring Business Regulations – Methodology*, available at: *http://www.doingbusiness.org/methodology*, last visited on January 15, 2015.

| Nature of Provision | Weights |
|---|---|
| Less burden/cumbersome | 1 |
| Reasonable burden/cumbersome | 2 |
| Significant burden/cumbersome | 3 |

**Table 2.2** sets out the comparison of legislations with respect to debt recovery

**Table 2.2: Comparison of Legislations**

| Indicators | Legislations | | | | |
|---|---|---|---|---|---|
| | **SICA** | **LSA Act** | **DRT Act** | **SARFAESI Act** | **2013 Act** |
| **1. Time** | No specified time limit within which BIFR / AAIFR is required to conclude the proceedings. **(Weight 3)** | Expeditious compromise /settlement between parties. However, no specific time limit is stipulated. **(Weight 2)** | 1. RTs should **endeavour** to dispose of the cases within 180 days (recommendatory timeline).<br><br>2. DRATs should **endeavour** to dispose the appeal within 6 months (recommendatory timeline). **(Weight 2)** | 1. 60 days for discharging the unpaid liabilities (from the date of notice issued u/s 13(2) of the Act).<br><br>2. 15 days for disposing of the objections, if any, (from the receipt of objection pursuant to the notice u/s 13(2)).<br><br>3. No time limit is prescribed for the DM /CMM to take possession of the secured assets / documents and forward the same to the creditor. **(Weight 3)** | More than 1 year. **(Weight 2)** |
| **2.Procedure** | BIFR and AAIFR **(Weight 2)** | *Lok Adalat* **(Weight 1)** | DRT and DRAT **(Weight 2)** | CM /DMM **(Weight 1)** | NCLT and NCLAT **(Weight 2)** |
| **3.Costs** | *Not* | No Fee | 1. | No Fee | *Not* |

| Indicators | Legislations | | | | |
|---|---|---|---|---|---|
| | SICA | LSA Act | DRT Act | SARFAESI Act | 2013 Act |
| | *Applicable** | **(Weight 1)** | Application Fee - ₹150,000 (max.)<br>2. Fee for filing appeal - ₹30,000 (max.)<br>**(Weight 2)** | **(Weight 1)** | *Applicable** |
| **Recovery Rate** | *Not Applicable** | 6.03 percent **(Weight 3)** | 9.58 percent **(Weight 2)** | 25.79 percent **(Weight 2)** | *Not Applicable** |
| **Total Weights** | **5** | **7** | **8** | **7** | **4** |

**No score is assigned if information is not available in public domain.*
***Recovery rate is the as per the Statistical Tables relating to Banks in India, published by the RBI, (available at: http://dbie.rbi.org.in/OpenDocument/opendoc/openDocument.jsp, last visited on January 15, 2015)*

### *Indicator 4: Focus on debt recovery*

While the scores of Legal Services Authorities Act, 1987 and SARFAESI Act, 2002 are equal, the SARFAESI Act is directly attributable to the problem of debt recovery (problem identified for undertaking RIA). No other statute was specifically legislated for the purpose of dealing with debt recovery procedure other than DRT Act and SARFAESI Act, making them more relevant than others for the current project.

### *Indicator 5: Legislations in force and evidence of debt recovery*

- SICA, 1985 was repealed and replaced by the Sick Industrial Companies (Special Provisions) Repeal Act, 2003. However, legal hurdles prevented the 2003 Act is yet to be made effective. Consequently, performing RIA on SICA would not be relevant.
- A prerequisite for RIA for designing amendments to existing legislations is availability of evidence of effectiveness of implementation of the legislation. As the Companies Act, 2013 was enacted as late as in 2013, given the limited time of its implementation, especially with respect to chapter XIX in relation to sick companies, it might be too early to undertake detailed impact assessment of the legislation.

**Selection**
Based on the above, the DRT Act and SARFAESI Act, having the highest score in the comparison under Table 2.2, i.e. 8 and 7 respectively, indicating high burdensomeness, and given their relevance to the issue and availability of evidence of their implementation, seem to be most appropriate legislations for the purpose of this study[53]. In addition, during the NRG meeting organised for validation of research methodology, the experts attending the

[53] Available at: http://www.cuts-ccier.org/BHC-RIA/

meeting agreed with the aforementioned approach of undertaking RIA of the aforesaid two legislations.[54]

The following chapters will discuss in detail the provisions of Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT Act) and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act/Securitisation Act) in addition to the rules framed in the respective statues in detail and highlight potential sub-optimal provisions and issues that might have been left uncovered under these legislations.

[54] The report of national reference group meeting is available at: *http://www.cuts-ccier.org/BHC-RIA/pdf/report-First_NRG_Meeting_Facilitating_the_adoption_of_Regulatory_Impact_Assessment_Framework_in_India.pdf*.

# *Chapter 3:*
# Description of Select Legislations

## 1. Background

As described in the earlier chapter, legislations selected for undertaking RIA under the project are the DRT Act and the SARFAESI Act. Prior to undertaking in-depth RIA and loopholes in these legislations, it is imperative to understand the process envisaged in the select legislations to achieve their desired objective of speedy recovery of debts to deal with the problem of NPAs being faced by banks and financial institutions. This chapter summarily describes the procedure envisaged under these legislations.

Further, in order to effectively undertake RIA, review of the law making process, in general *vis-à-vis* the law making process of select legislations, in particular, is crucial in order to understand the extent of analysis, stakeholder involvement and impact assessment prescribed/undertaken during formulation of these legislations. This chapter intends to highlight the general law making process in India. Also, an attempt has been made to compare the same with the law making procedure of the DRT Act and SARFAESI Act, assessed on the basis of available literature and stakeholder consultations in subsequent sections of this chapter.

## 2. Procedure Envisaged under Select Legislations

This section provides the process enshrined in relation to debt recovery under select legislations – the DRT Act and the SARFAESI Act.

### *2.1. RDBFI Act/DRT Act*

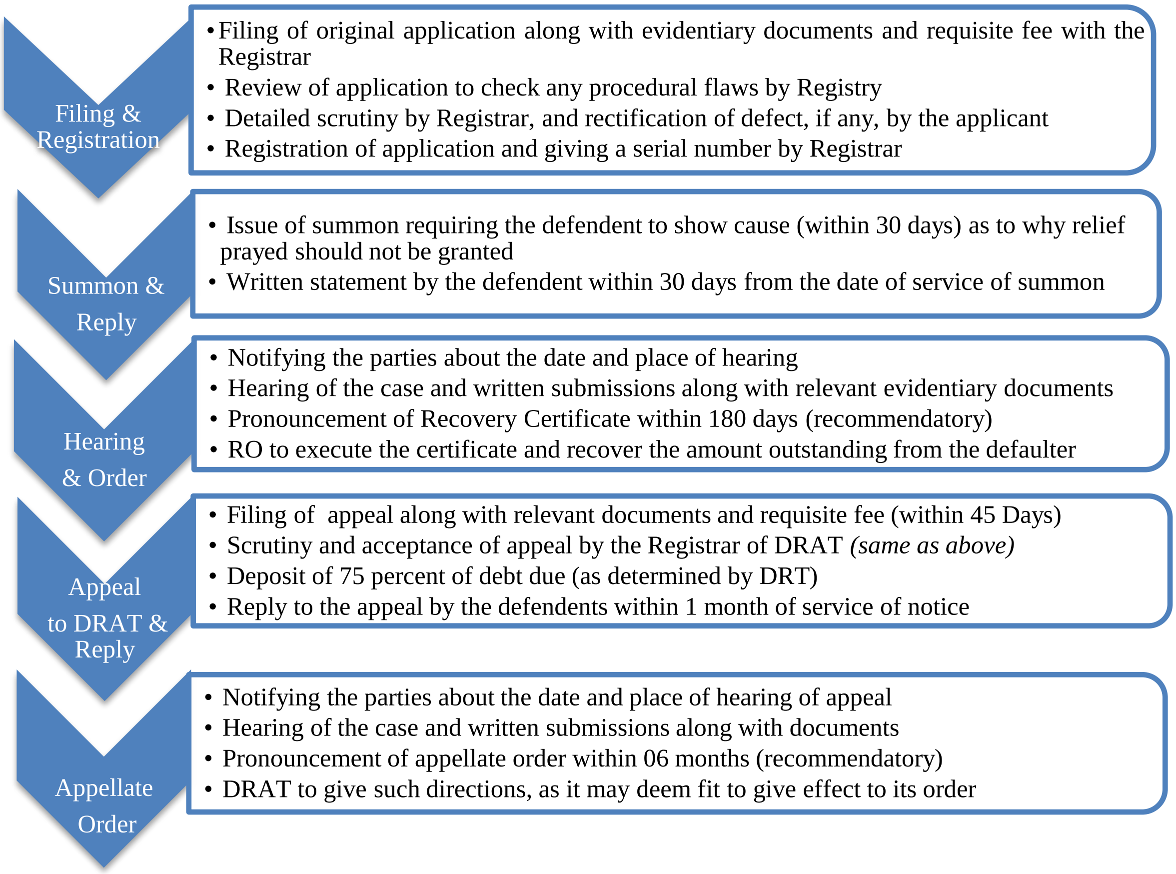
The DRT Act was enacted to facilitate speedy recovery of debts due to banks and financial institutions. The RTs were set up under the DRT Act to ensure speedy adjudication of the cases and swift execution of verdicts. These tribunals are quasi-judicial institutions set up to process the legal suits filed by banks and financial institutions against defaulting borrowers. Such tribunals are supposed to exercise their jurisdiction, power and the authority conferred on them as per the relevant provisions of the Act.

As regards the composition of DRT, it is headed by a Presiding Officer (PO) who acts as the adjudicatory officer of the tribunal. It also consists of a number of staff in the Registry, which is responsible for accepting applications and filing of cases with the DRT. The Registry is headed by a Registrar who performs the functions of a Judicial Officer till the case is transferred to the PO for final hearing. The DRT Act also provides for the Recovery Officers (RO) for executing the decree and eventually realising the debt amount from the defaulting borrowers.

Further, the DRATs were also established under the DRT Act, 1993. These appellate tribunals have appellate jurisdiction on all matters concerning the recovery of debts in India. An appeal against the order of DRT can be made before the DRAT within 45 days from the date of DRT order.[55] A DRAT is headed by a Chairperson, to be appointed by the Central Government by issuing notification in this regard. The DRT Act requires the DRAT to deal with appeal filed expeditiously and an endeavour should be made to dispose it within six months from the date of receipt of appeal.

For a diagrammatic representation of the process of debt recovery under the DRT Act (including appellate proceedings before the DRAT) see Figure 3.1.

**Figure 3.1: Debt Recovery under the DRT Act**




### *2.2. SARFAESI Act/Securitisation Act*

The SARFAESI Act was legislated to enable banks and financial institutions to enforce their security interest without having to resort to courts and tribunals so as to recover their dues rather speedily. The Act provides three alternative methods for recovery of debts due to banks/financial institutions, namely:-

- Securitisation
- Asset Reconstruction
- Enforcement of security interest without intervention of court

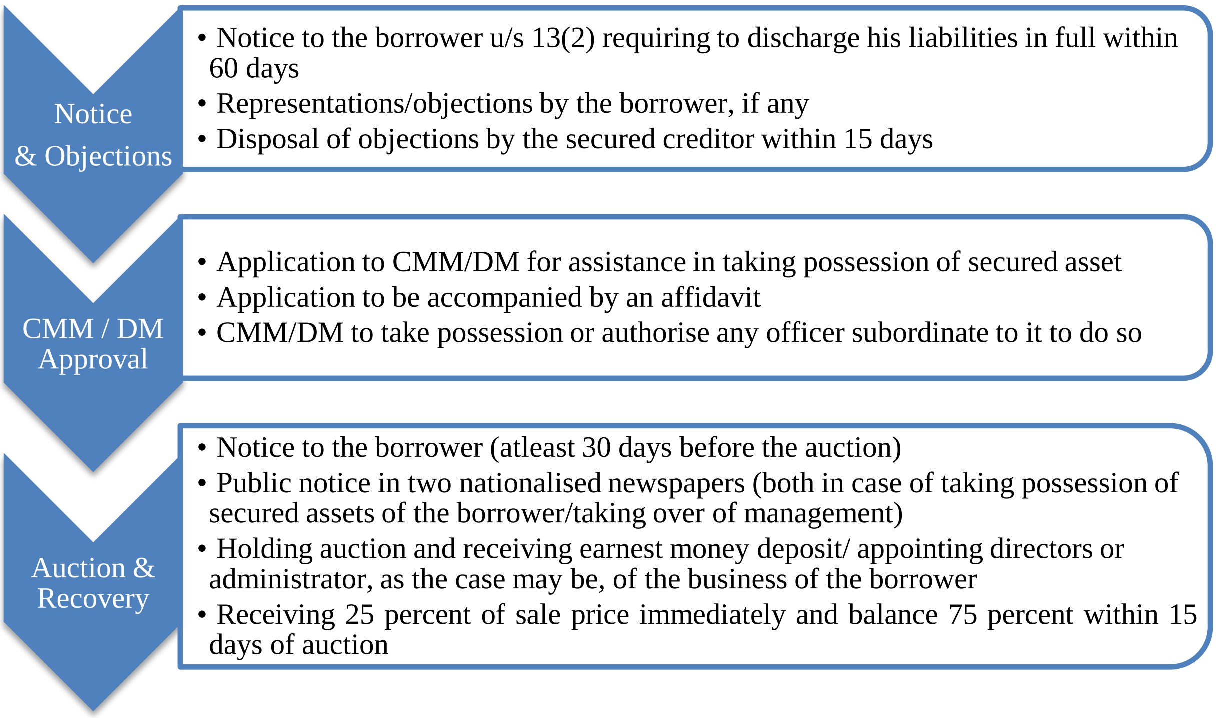
[55] Section 20 of the DRT Act.

SARFAESI Act also provides for setting up of Securitisation Companies/Reconstruction Companies (SC/RC), which acquire the NPAs from banks and financial institutions by issuing security receipts, representing undivided interest in such financial assets. It enables SC/RCs to take possession of secured assets of the borrowers including right to transfer and realise the secured assets. SC/RCs act as debt aggregators of the banks or financial institutions focused in the resolution the problem of NPAs.

Furthermore, under the SARFAESI Act, banks/SCs/RCs are given the power to take over possession of secured assets from the defaulter and sell such securities for the purpose of recovery of the loan without going through the stringent court procedure. The bank can take possession within 60 days of serving the notice to the defaulter with the assistance of the Chief Metropolitan Magistrate/District Magistrate (CMM/DM). Once a request for taking possession or control of secured asset is received by the CMM/DM, it might take possession of such assets and documents relating thereto, and consequently, forward the same to the secured creditors.

For a diagrammatic representation of the key steps of enforcement of security interest under the SARFAESI Act see Figure 3.2**.**

**Figure 3.2: Key Steps under SARFAESI Act**




## 3. Law Making Process in India

The elements of RIA need to be incorporated in the law making process, and therefore, as mentioned above, review of the law making process is imperative for the purpose of effectively undertaking RIA. This section sets out a brief analysis of the general law making process in India. Further, the same is compared with law making procedure adopted under the

DRT Act and the SARFAESI Act, on the basis of literature review and stakeholder consultation, to identify any lacunae in the law making procedure of the select legislations *vis-à-vis* the general law making process in India.

### *3.1. Legislative Process in India*

In India, the law making bodies are Parliament at the central-level and Legislative Assemblies and Councils (wherever applicable) at the state-level. Parliament consists of two Houses: the Lok Sabha or 'House of the People' and the Rajya Sabha or 'Council of States'. The process of law making, in relation to the Parliament may be defined as the process by which a legislative proposal brought before it, and then is translated into the law of the land. It can be broadly divided into three stages /phases – Pre-legislative phase, Legislative phase and Post-legislative phase.

Pre-legislative phase comprises identification of need for a new law or an amendment to an existing legislation, drafting of the proposed law, seeking inputs/comments from different ministries and public, revision of the draft bill to incorporate such inputs, and getting the same vetted by the Law Ministry. It is then presented to the Cabinet for approval. [56]

The Government has issued a Pre-legislative Consultation Policy to ensure efficient pre-legislative scrutiny of a legislative proposal, in consultation with the stakeholders. It includes publishing/placing in public domain:[57]

- the draft legislation or at least the information that may *inter alia* include brief justification for such legislation, essential elements of the proposed legislation, its broad financial implications, and an estimated assessment of the impact of such legislation on environment, fundamental rights, lives and livelihoods of the concerned/affected people, etc.
- an explanatory note explaining key legal provisions of the draft legislation or rules in a simple language and
- the summary of feedback/comments received from the public/other stakeholders.

In addition, the Department/Ministry concerned is also required to include a brief summary of the feedback received from stakeholders (including Government Departments and the public) along with its response in the note for the Cabinet along with the draft legislation. The summary of pre-legislative process is also required to be placed before the Department Related Parliamentary Standing Committee by the Department/Ministry concerned when the proposed legislation is brought to the Parliament and is referred to the Standing Committee.

After the Cabinet approves the Bill, it is introduced in the Parliament. On introduction of the Bill, the Minister of the concerned Department may send notice demonstrating the intention that the Bill may be moved, considered and passed; be referred to the Select Committee of the House/Joint Committee of both Houses or for eliciting public opinion. Once the Bill is taken for consideration, perusal must be made on clause-to-clause basis and the same may be

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[56] Procedure drawn from the Manual of Parliamentary Procedures in the Government of India Chapter on Legislations, accessed from: *http://mpa.nic.in/mpa/Manual/Manual_English/Chapter/chapter-09.htm* and also from Decisions taken in the meeting of the Committee of Secretaries (CoS) held on January 10, 2014 under the Chairmanship of Cabinet Secretary on the Pre-legislative Consultation Policy (PLCP) accessed from *http://lawmvin.nic.in/ld/plcp.pdf*

[57] Pre-Legislation Consultation Policy, February 05, 2014.

accepted, amended or rejected. Subsequently, the House votes on the Bill with amendments, if any. If the Bill is passed in one House, it is then sent to the other House. In case of a deadlock between the two houses or in case where more than six months lapse in the other House, the President may summon, though is not bound to, a joint session of the two Houses, which is presided over by the Speaker of the Lok Sabha and the deadlock is resolved by simple majority.

Once the Bill is passed by both the Houses, a copy of the Bill is sent to Legislative Department of Ministry of Law and Justice for scrutiny. Post scrutiny by the Ministry of Law and Justice, it is presented to the President for assent. The President has the right to seek information and clarification about the Bill and may also return it to the Parliament for reconsideration.[58]

After the President gives assent, the Bill is notified as an Act. Subsequently, the Bill is brought into force, and the rules and regulations to implement the Act are framed by the concerned Ministry. The same are then tabled in the Parliament.

### *3.2. Challenges in relation to legislative process*

The manner in which policy or legislations are drafted is often questioned by both the experts as well as those who practice. The legislative process is itself inherited with numerous challenges/lacunas. Some of them are outlined below:

#### *3.2.1. Deficit of elements of impact assessment in Manual on Parliamentary Procedures in India (Manual)[59] and Pre-legislative Consultation Policy (PLCP)*

As indicated earlier, the law making process in India in general includes certain aspects of impact assessment (IA), such as inviting public comments on the draft legislation, consultation with relevant stakeholders, and study of social and financial costs/benefits.[60] However, it seems that the requirement is often not complied with as it is not mandatory and the process has led to certain ambiguities. While the Manual on Parliamentary Procedures in India (Manual) does not mandate any stakeholder consultation *per se*, but the PLCP requires undertaking stakeholder consultations. Yet neither the Manual nor the PLCP describes the process of conducting these stakeholder consultations and manner in which all interested parties would need to be represented. Lack of availability of information in public domain acted as one of the challenges in determination of quality of public consultation under the legislations under consideration.

#### *3.2.2. Dearth of interconnection between Manual and PLCP*

The Manual is the principle document for ascertaining law making process in India that exhaustively explains the process. However, the PLCP has an over-ridding effect over the Manual (to the extent of pre-legislative process) and it is difficult to ascertain the junctures at which provisions under PLCP will be read along with the Manual.

#### *3.2.3. Lack of transparency in inviting and accepting Public Comments*

The Manual and PLCP mandates the concerned department to invite public comments on draft legislations. But, there are no specific provisions that mandate the relevant department

[58] Ibid.
[59] On Parliamentary Procedures of Government of India, Lok Sabha Rules.
[60] See, the Pre-legislative consultation policy (PLCP) (issued in the year 2014).

concerned for providing rationale as to acceptance or non-acceptance of any recommendations. A mechanism of feedback to the stakeholders in terms of providing rationale is important to ensure transparency and to also ensure a sense of ownership on part of the stakeholders towards the draft legislations.

*3.2.4. Cabinet note in the Office Memorandum*

Cabinet Note is part of the office memorandum that explains objective behind the draft legislation. However, it is not a public document making it difficult for the stakeholders to ascertain rationale and objective behind the legislation.

### *3.3. Legislative Procedure of the select debt recovery laws (DRT Act /SARFAESI Act)*

On the basis of available literature in public domain and stakeholder consultations, the SARFAESI Act and the DRT Act seem to be subject to the following gaps:

*3.3.1 Deviation from standard procedure of law making*

The Manual mandates that a bill needs to be referred to a related Standing Committee. Deviation from the standard procedure was observed in adoption of DRT Act and Securitisation Act as instead of referring the relevant bills of the concerned legislations to Standing Committee on Finance, the Ordinance route[61] was taken to ensure their passage.[62]

*3.3.2. Non availability of reports*

The Lok Sabha debates refer to formation of several Committees and their reports highlighting the problems faced by the economy leading to requirement of the legislations. Unfortunately, these reports were not easily available in the public domain. For example, the Committee on Estimates (1998-1999) of the 12th Lok Sabha worked on the issue of bad debts and accordingly made certain recommendations in a Report.

In addition, owing to availability of limited information in public domain it is not clear if the primary legislations were subject to in-depth discussions or with all concerned stakeholders. However, research with respect to amendments of legislations revealed that text of certain amendments was changed after introduction and certain amendments were introduced in Rajya Sabha,[63] and not in Lok Sabha, indicating to the practice of discussion of amendments in Parliament.

While this chapter sets out the procedure in relation to debt recovery, as stipulated under the aforesaid legislations in addition to general law making process, the following chapter will discuss the legislative issues/problems under the said legislations. This will help to identify possible lacunae impending achievement of objectives of speedy debt recovery.

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[61] Such as the Recovery of Debts Due to Banks and Financial Institutions Ordinance, 1993, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (Second) Ordinance, 2002, etc.

[62] On expiration of both the ordinances, the bills were subsequently introduced and passed in the parliament.

[63] In 2012, amendments to Sections 5(1)(5), 9(g) and 13(9) of Securitisation Act, and amendments to Sections 15 (proviso), 19(3A), 19(5), 19(5A), 36(2)(cc) to the DRT Act were introduced in Rajya Sabha and not in Lok Sabha.

# *Chapter 4:*
# Understanding the Baseline

## 1. Background

In the previous chapters, legislations selected to undertake RIA are the DRT Act and the SARFAESI Act were discussed. This chapter intends to correctly understand the current scenario/baseline in relation to low debt recovery, on the basis of in-depth analysis of the two legislations to identify lacunae/sub-optimal provisions impending speedy debt recovery. In addition, issues left uncovered under these legislations (if any) but important for achievement of legislative objectives have been highlighted.

The analysis has been done through literature review, review of existing research and expert reports, primary data collection, analysis and stakeholder consultations undertaken under this project. In order to collect relevant data and information various publicly available sources, such as websites of RBI, Ministry of Finance, RTs, etc. and publications in international journals were reviewed. Also, an analysis of select cases pending before/disposed of by Chennai DRAT was undertaken to gain in-depth understanding.

Stakeholders consulted for collection of quantitative and qualitative information included banks, (public and private sector), legal practitioners and consultants, rating agencies, government/regulatory bodies, sector experts and members of NRG of the project, comprising sitting and former government officials.[64] The process involved finalisation of survey tools i.e. semi-structured questionnaires, followed by one-to-one interviews/interactions and focus group discussions. Banks and financial institutions were consulted to understand the practical problems faced in debt recovery, and obtain relevant data in relation to amount and time involved in the recovery process. Legal consultants/advisers provided insights of legal proceedings in relation to debt recovery. Government/regulatory bodies (including former government officials) helped understanding the law making process, and role of regulators/government in recovery of debt. Sector experts were consulted to understand problems in relation to recovery of debts and obtain their views on the feasible alternatives.

The following sections are divided into two broad heads of DRT Act and SARFAESI Act. Each section provides an analysis of issues under specific legislations, and highlights the findings of data collection and stakeholder interaction exercise, wherever relevant.

## 2. DRT ACT

As discussed earlier, DRT Act established RTs as dedicated adjudicatory bodies to deal with issues of debt recovery, and enable speedy recovery of due amounts. However, it failed to

[64] List of members of the NRG is available at *http://www.cuts-ccier.org/BHC-RIA/pdf/NRG-Members.pdf*

achieve this objective by a significant mark. This is evident from the fact that as on March 31, 2014, 66,971 matters amounting to ₹1,415bn are pending at DRTs.[65]

This is because its provisions leave the scope for delay in decision making at RTs; or otherwise impede performance of DRTs. Table 4.1 provides a summary of the issues relating to the DRT Act.

**Table 4.1: Issues Relating to DRT Act**

| Delay in decision making | Issues impeding performance |
|---|---|
| • Absence of the mandatory time limits for disposal of matters<br>• Low benchmark for filing applications<br>• Insufficient recovery tribunals (RTs, combined reference for DRTs and DRATs)<br>• Inadequate composition of RTs<br>• Sub-optimal process of filling vacancies<br>• Inefficient recovery process<br>• Grant of several adjournments and irregular hearing of matters<br>• Adoption of civil suit procedure<br>• Exercise of jurisdiction by other courts/ authorities<br>• Sub-optimal procedure in relation to issue of summons and<br>• Inefficient provisions in relation to filing of written statement by defendant | • Inadequate qualifications of Presiding Officers (POs) and Chairperson and sub-optimal composition of RTs<br>• Inefficient appointment procedure for PO and Chairperson<br>• Absence of *bonus-malus* system for PO and Chairperson<br>• Absence of provisions to ensure adequate performance by staff of RTs<br>• Lack of clarity on powers of RTs<br>• Existing of statutes overriding DRT Act<br>• Simultaneous proceedings under the DRT Act and the Securitisation Act and<br>• Absence on clarity on priority of creditors' claims |

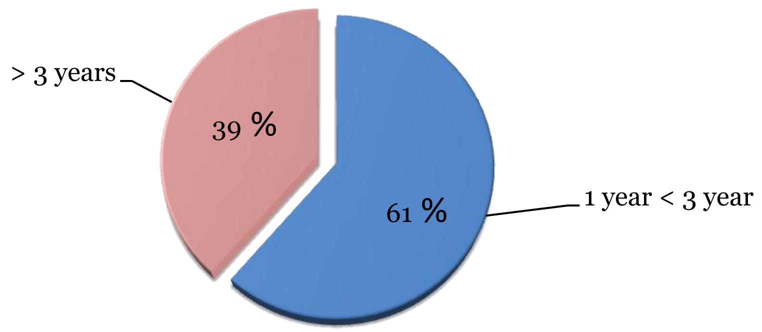
### *2.1. Delay in decision making process*

According to the Annual Review (2011-12) of the Internal Audit Wing of Ministry of Finance, Government of India, out of total 1,113 Original Applications or OA (involving total amount of ₹1,620.84 crore) pending with Chandigarh DRT-II as on March 31, 2011, about 429 OAs were pending for more than three years and remaining 684 for more than one year.[66] In other words, not even a single OA pending before the Chandigarh DRT-II in 2011got disposed of in less than a year. Figure 4.1 provides a diagrammatic representation of the pendency of OA before PO of Chandigarh DRT II.

[65] R Gandhi, *Workshop for Judges of ATs and Presiding Officers of DRTs* conducted by CAFRAL on December 29, 2014, available at: *http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/BDRRS010115.pdf*, last visited on March 10, 2015.

[66] Annual Review of Internal Audit Wing of Ministry of Finance, 2011-12.

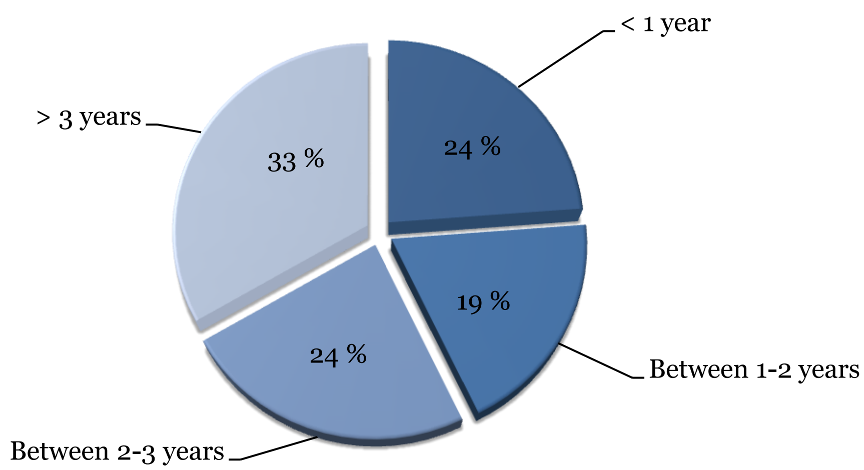
**Figure 4.1:Pendency of OA before PO of Chandigarh DRT-II as on March 31-2011**




*Source: Report of Internal Audit Wing, 2011-12, Ministry of Finance*

Similarly, a study[67] was recently conducted in relation to matters pending at Delhi DRT. Comprehensive data in relation to life of 21 matters (randomly selected) was collected and analysed. Matters included OAs, applications filed under SARFAESI Act, recovery matters, stay applications, etc. One-third of the cases analysed were pending for more than 3 years. The review revealed that delays were largely driven by trial failures.[68] Of the number of times matters were listed for hearing, nearly 59 percent of times trial failures were observed. These were because of reasons like RO on leave, applicant's lawyers stuck in traffic, confused/ complicated accounts, etc. Figure 4.2 provides a diagrammatic representation.

**Figure 4.2: Cases Pending before PO of Delhi DRT-I**




*Source: Case study done by NIPFP & IGIDR, August 2014*

[67] *'Study on Understanding cases at the Debt Recovery Tribunal'*, undertaken by the National Institute of Public Finance and Policy (NIPFP) and Indira Gandhi Institute of Development Research (IGIDR) in August, 2014.
[68] A trial failure means an event when the courts / tribunals are prevented from conducting its business.

The above findings were corroborated by stakeholder consultations under the project, which revealed that it normally takes at least 2-3 years under the DRT route before the actual recovery of bank dues takes place. Problems in obtaining the decree were highlighted as principal reason for delay in recovery. The stakeholders also revealed that even after obtaining the decree, it takes considerable time to obtain and execute the recovery certificate.

Experts have also raised concerns that only about one-fourth of the cases pending at the beginning of the year get disposed of during a particular year – suggesting a four year wait even if the tribunal focus only on old cases.[69]

Following factors are attributable to the delay in decision making:

*2.1.1. Absence of the mandatory time limits for disposal of matters*

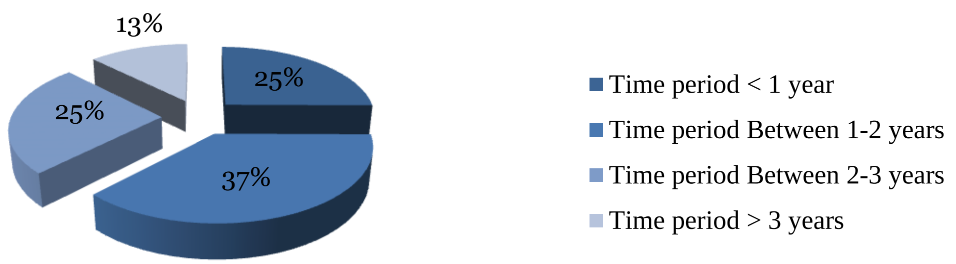
An application made to DRT is required to be dealt expeditiously and the DRT must make an endeavour to dispose of the same within 180 days.[70]An appeal against the order of DRT may be filed with DRAT within 45 days of receipt of the order of DRT. The DRAT can entertain appeal after the expiry of 45 days if it is satisfied that there was a sufficient cause for not filing the same within the prescribed 45 day period. Besides, a DRAT is required to deal with appeal filed expeditiously and make an effort to dispose it within 6 months from the date of receipt of appeal.[71]

Consequently, the DRT Act prescribes a *reasonable effort* obligation on the RTs but does not require them to *mandatorily* dispose of application within a specific period. As evident from Figure 4.1 and 4.2 and stakeholder consultations under the project, the recommendatory time period is rarely complied with. The proceedings before the DRTs often takes more than 2 years and if the matter goes into appeal to the DRAT, further time is taken and 3 years elapse before any recovery takes place.[72]

This was corroborated with data collected and analysed under the project. A study of randomly selected cases pending before/disposed by select DRTs (Chandigarh DRT, Jabalpur DRT, Jaipur DRT and Lucknow DRT) revealed that around 75 percent of cases were dragged for more than a year. The stakeholder consultations revealed that around 2 months are taken to just number the original applications (OAs) and record the case. Figure 4.3 provides a diagrammatic representation.

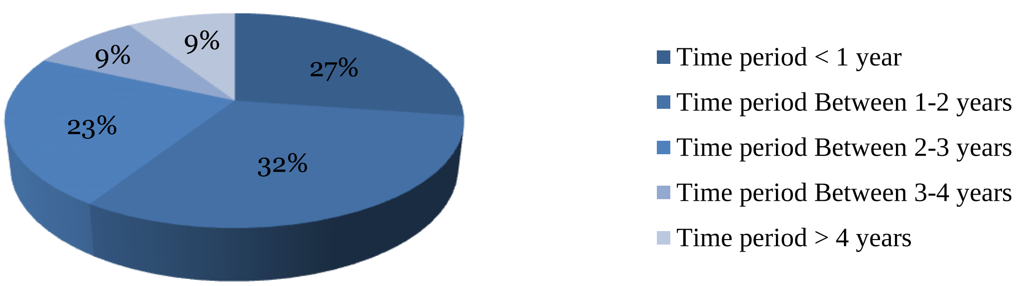
[69] Supra note 45.
[70] Section 19(24) of the DRT Act.
[71] Section 20(6) of the DRT Act.
[72] See, '*A Hundred Small Steps'*, A Report of the Committee on Financial Sector Reforms, Planning Commission of India.

**Figure 4.3: Cases pending before Chandigarh RT, Jabalpur RT, Jaipur RT and Lucknow RT**




Furthermore, a detailed analysis of lifetime (to the extent available in public domain)[73] of 22 cases (randomly selected) pending at DRAT Chennai was carried out under the project, based on the information available in the public domain (in form of 'A-Diary').[74] The results corroborate with the findings in other DRTs, and show that around 73 percent cases were pending for more than one year, and recommendatory time period under the DRT Act was not complied with.[75] It was observed that delays have largely been driven by presumably avoidable reasons like Chairman/RO on leave, electricity failure/power cut, strike of lawyers/ advocates' boycott, etc. Figure 4.4 provides diagrammatic representation.

**Figure 4.4: Appeals Pending before Chennai AT**




This is a result of lax enforcement of recommendatory provisions with respect to disposal of applications, and absence of mandatory prescriptions. As no reasons are required to be given in case an application/appeal is not disposed of within the period specified, the RTs are not made accountable for their sub-optimal performance. There is also no requirement for the DRAT to record the reasons for entertaining appeal filed beyond the 45 day period. Such sub-optimal accountability provisions result in overflow and consequent delay in disposing of applications/appeals, delaying recovery of debts. Besides, an absence of practice of Judicial

[73] The information in public domain is for a limited period (say, 2010-2014). The cases might have been instituted prior to beginning of that period and could continue subsequent to end of such period
[74] Chennai DRAT, A Diary, available at: *http://www.drat.tn.nic.in/ADiary.htm*
[75] However, it must be noted that the analysis is subject to limited publicly available information, and does not comment on the reasons for delay.

Impact Assessment[76] and inability to correctly estimate the technical and manpower capacity requirement has resulted in non-compliance with the time periods mentioned in the statute.

*2.1.2. Low benchmark for filing applications at DRTs*

The DRT Act came into force in 1993. It provided that the minimum amount of debt due, eligible for bringing action under DRT Act was ₹10 lakh unless specified otherwise by a notification issued by the government.[77] Consequently, only high value claims were envisaged to be dealt under the DRT Act. However, after around two decades of promulgation of the DRT Act, the minimum amount eligible for filing of applications has not been revised. Further, the maximum application fee for filing of application has remained ₹1.5 lakh[78] since 1993.

Collection of fees from the stakeholders, and consequent reduced financial dependence on government resources is a critical sign of independence for any regulatory institution. However, absence of periodic review and revision of such fee amount impedes achieving such desired financial independence.[79]

As on March 31, 2014, nearly 66,971 matters amounting to ₹1,415bn were found to be pending at 33 DRTs.[80] It could be reasonably presumed that had the minimum amount and application fee been periodically revised, the number of matters pending and amount of pendency would not have been as much. Low eligibility criteria increase the possibility of filing of insignificant matters at the RTs contrary to the objective of DRT Act, resulting in overburdening of adjudicatory officers, and consequent delays in recovery proceedings.

A related point is that at the time of establishment of RTs, the government would have made provision for technical and manpower support to RT, required to deal with high value claims. However, on account of non-revision of minimum permissible amount, and consequent filing of low value claims, the RTs would have been facing capacity constraints.

This was validated during stakeholder consultations wherein it was revealed that RTs have remained under-equipped and short-staffed to deal with increasing volume of cases.[81]

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[76] Probable burden of legislation on judiciary. Judicial Impact Assessment has been recommended by report of Task Force on Judicial Impact Assessment, chaired by Justice M Jagannadha Rao, (2008). The report notes, "*Further, there must be 'judicial impact assessment', as done in the United States, whenever any legislation is introduced either in Parliament or in the State Legislatures. The financial memorandum attached to each Bill must estimate not only the budgetary requirement of other staff but also the budgetary requirement for meeting the expenses of the additional cases that may arise out of the new Bill when it is passed by the legislature. The said budget must mention the number of civil and criminal cases likely to be generated by the new Act, how many courts are necessary, how many judges and staff are necessary and what is the infrastructure necessary*".

[77] Section 1(4) of the DRT Act. The cases below the prescribed threshold would generally be referred to *lok adalats*, civil courts, or the lenders could take action under the SARFAESI Act. Some of these mechanisms have their own minimum thresholds.

[78] The DRT (Procedure) Rules, 1993.

[79] Moreover, as per the statutory provisions, the application fees may be remitted either in the form of crossed demand draft drawn on a nationalised bank or through a crossed Indian Postal Order.[79] Non-acceptance of demand draft drawn on a bank other than a nationalised bank is a competition distortionary policy, which has the potential to result in inconvenience of parties.

[80] Supra note 70.

[81] The Supreme Court in the matter of *Union of India v. DRT Bar Association* (decision dated January 22, 2013) highlighted the infrastructure constraints faced by RTs. The government had pledged to fix the situation by taking appropriate measures. However, no improvement has been observed in this regard.

Stakeholder interactions also revealed that the RTs are facing financial constraints and the fee received by RTs is not sufficient to even meet its office and administrative cost.[82]

Consequently, absence of periodic review of minimum permissible amount and application fee to trigger the RT proceedings, has resulted in overburdening of RTs, resulting in RTs facing resource constraints.

*2.1.3. Insufficient RTs*

Section 3 of the DRT Act authorises the central government, by way of notification, to establish one or more DRTs, including the areas within which these DRT may exercise jurisdiction. The DRT Act also empowers the central government to establish one or more DRATs, and specify their jurisdiction. The DRT Act, however, does not provide any guidance on the factors which should be considered while establishing RTs[83], or the need to ensure existence of adequate number of RTs, or the necessity to undertake periodic review of number of RTs in the country.

Consequently, as on date, there are 33 DRTs and 5 DRATs[84] with some states have more than one DRT[85] and some do not having even one exclusive DRT[86]. No intelligible classification is available in public domain justifying neglect of some states and focus on others while establishment of DRTs.

Stakeholder consultations revealed that jurisdiction of these RTs have not been intelligently thought of. It was mentioned that jurisdiction has been divided on the basis of geography and no review of expected pendency was carried out. Thus while some of the DRTs are dealing with huge backlog of cases, situation might be better in some others.[87] Lack of proper due diligence for work allocation at DRTs seem to have resulted in this. The situation is no better at DRATs with each DRAT having appellate jurisdiction over multiple DRTs.[88]

On an average, approximately 2,000 cases are pending per DRT at present, which is virtually 2.5 times of adequate number of cases ought to be pending, in accordance with the recommendations of the Deshpande Committee.[89]

While the government has plans to establish six new DRTs,[90] one is not aware by when such DRTs will be functional. Consequently, absence of statutory requirement to ensure

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[82] *Debt Recovery Tribunals in dire straits*, available at: *http://articles.economictimes.indiatimes.com/2014-06-09/news/50448255_1_drts-stamps-government-owned-banks*, last assessed on March 10, 2015.

[83] Such as, on the basis of population/case load.

[84] List of DRATs/DRTs, available at: *http://financialservices.gov.in/banking/ListOfDRATsAndDRTS.asp?pageid=1*, last visited on January 17, 2015

[85] Maharashtra has five DRTs (three in Mumbai and one each in Nagpur and Pune).

[86] All North-eastern states have access to a singular DRT in Guwahati.

[87] For instance, as on March 31, 2014, more than 1,000 matters are pending at DRT-Chennai I, but the total number cases pending at DRT-Chennai II and III on a consolidated basis is less than 900, on the same date. Similar is the case with tribunals in Delhi and Mumbai.

[88] The DRATs are situated in Allahabad, Chennai, Delhi, Kolkata and Mumbai. Each DRAT is appellate authority of multiple RTs based on a particular geographical area. For example, Allahabad DRAT has jurisdiction over three DRTs viz., Allahabad DRT, Lucknow DRT and Jabalpur DRT covering four States of Uttar Pradesh, Uttarakhand, Madhya Pradesh and Chhattisgarh.

[89] According to the Report of the 'Working Group to Review the functioning of DRTs', under the Chairpersonship of N V Deshpande (Former Legal Advisor of RBI), the presiding officer of DRT should not have more than 30 cases on board on any given date and there should not be more than 800 cases pending before it any given point of time.

establishment of adequate RTs, and review the number of RTs on a periodic basis has resulted ininadequate number of RTs, overburdening of existing RTs, and delaying the decision making process.

*2.1.4. Inadequate composition of RTs*

DRT consists of one person only i.e. a Presiding Officer, who, per DRT Act could be authorised to discharge functions of PO of another DRT.[91] Similarly, a DRAT consists of one person only, i.e. Chairperson who could be authorised to discharge functions of Chairperson of other DRAT.[92]

DRTs have witnessed exponential increase in matters filed on an annual basis, in last 5 years (2009-10 to 2013-14), from 6,019 to 28,258[93], (around 469 percent). This means that on a daily basis, around 100 new matters were filed in DRTs in fiscal 2014. And this rate is expected to further rise. It might be beyond the capacity of 33 persons (one PO per DRT), to expeditiously deal with such increase in filing.

Further, if a PO/Chairperson is temporarily absent/on leave because of any unavoidable circumstances, all cases listed on the day are usually adjourned for two-three months, resulting in delay in decision making. A review of cases filed in Chennai DRT-III revealed that 15 cases listed before the PO on December 31, 2014 were adjourned to different dates, as the PO was away on duty.[94] Similarly, the PO was on leave on December 15, 2014. As a result, 34 cases were adjourned to different dates.[95] Similarly, more than 70 cases listed before the Chairperson of Chennai DRAT in the month of November, 2014 were adjourned to different dates, mostly after a two-month period[96] as the Chairperson was on leave.[97] Again, around 90 cases listed in the month of June, 2012 were adjourned to different dates because the Chairperson was on leave.[98] Stakeholder consultations revealed that on several occasions POs have not been available without ensuring any adequate backup. At times, the Chairperson of a DRAT takes the POs of DRTs under its jurisdiction for an offsite training during working days resulting in adjournment of matters and thus delay in decision making.

As mentioned earlier, PO/Chairperson could be authorised to discharge functions under other RTs (on account of unavailability of respective officers in such RTs). This often results in overburdening of PO/Chairperson(s) taking additional burden. During a review of functioning of different DRTs, it was found that for around six months (viz., from June to December, 2014), all matters listed for hearing before the PO of Chennai DRT-III were transferred to the PO of Chennai DRT-II.[99] Similarly, the Chairperson, Mumbai DRAT currently has an additional charge of the Chairperson, Chennai DRAT (since December

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[90] In terms of press release dated December 10, 2014, the Cabinet approved establishment of six new DRTs (taking the number up to 39), available at: *http://pib.nic.in/newsite/PrintRelease.aspx?relid=113073*, last visited on January 17, 2015. Interestingly, the budget documents do not specify any financial allocation for establishment of such DRTs.

[91] Section 3.

[92] Section 9 and 8(3).

[93] Report on Trends and Progress of Banking in India, Reserve Bank of India.

[94] Available at: *http://www.drt3chennai.tn.nic.in/CauseLists/31122014.htm*, last visited on March 10, 2015.

[95] Available at: *http://www.drt3chennai.tn.nic.in/CauseLists/15122014.htm*, last visited on March 10, 2015.

[96] This is despite a specific provision in the DRT Act relation to day to day hearings.

[97] Available at: *http://www.drat.tn.nic.in/A-Diary/01-30%20Nov%2014.htm*, last visited on March 10, 2015.

[98] Available at: *http://www.drat.tn.nic.in/A-Diary/01-30%20June%2012.htm*, last visited on March 10, 2015.

[99] Available at: *http://www.drt3chennai.tn.nic.in/CauseLists/16122014.htm*, last visited on March 10, 2015.

2014) on account of vacant position of the Chairperson, Chennai DRAT.[100] Consequently, this would overburden the PO/Chairperson taking additional charge of other RTs, resulting in delay in decision making and consequent recovery of debts due to banks and financial institutions.

The PO is also the appellate authority against order of Registrar declining to register an application filed before the DRT. This also could increase the number of matters PO has to deal with and consequently delaying decision making.[101]

Possibility of a single PO at the DRT is significant reason for the above-mentioned delays. The DRT Act does not require the government to ensure existence of sufficient number of POs, efficiently manage POs unavailability or provide reasons or guidance on the time period when PO/Chairperson of a DRT is assigned other DRT as additional responsibilities. This delays the decision making and thus delaying the debt recovery.

*2.1.5. Sub-optimal process of filling vacancies*

In case of any vacancy (other than temporary absence) at RT, the central government appoints another person in accordance with DRT Act, and the proceedings are continued before the relevant RT from the stage at which the vacancy is filled.

As indicated in the Table 4.2, the position of PO in certain DRTs at Chennai, Delhi, Nagpur and Patna remained vacant for almost 6 months, and in Chandigarh DRT, for a period of almost 4 months. This resulted in the delay in decision making and consequent delay in debt recovery.

**Table 4.2: Delay in Filling of Vacancies in DRTs**

<table>
<tr><th>S. No</th><th>DRT</th><th>Designation</th><th>Original status</th><th>Revised status</th></tr>
<tr><td>1</td><td>Chennai DRT- III</td><td rowspan="5">Presiding Officer</td><td rowspan="4">Vacant as on June 09, 2014</td><td rowspan="5">Appointment on December 17, 2014</td></tr>
<tr><td>2</td><td>Delhi DRT- I</td></tr>
<tr><td>3</td><td>Nagpur DRT</td></tr>
<tr><td>4</td><td>Patna DRT</td></tr>
<tr><td>5</td><td>Chandigarh DRT - I</td><td>Tenure up to September 01, 2014</td></tr>
<tr><td colspan="5">Source: The Department of Financial Services, Ministry of Finance, Government of India</td></tr>
</table>

The DRT Act neither does envisage any mechanism to detect potential vacancy prior to its occurrence nor does it provide for a reliable time bound mechanism within which such vacancy must be filled.

Under the current procedures, it could be reasonably assumed that the process to fill vacancy is initiated only after its occurrence resulting in loss of valuable time of stakeholders. The situation worsens in the absence of any statutory requirement to fill vacancy within a prescribed time frame. Inability to timely detect and fill vacancy on account of absence of statutory provisions requiring the same, delays the decision making and recovery process.

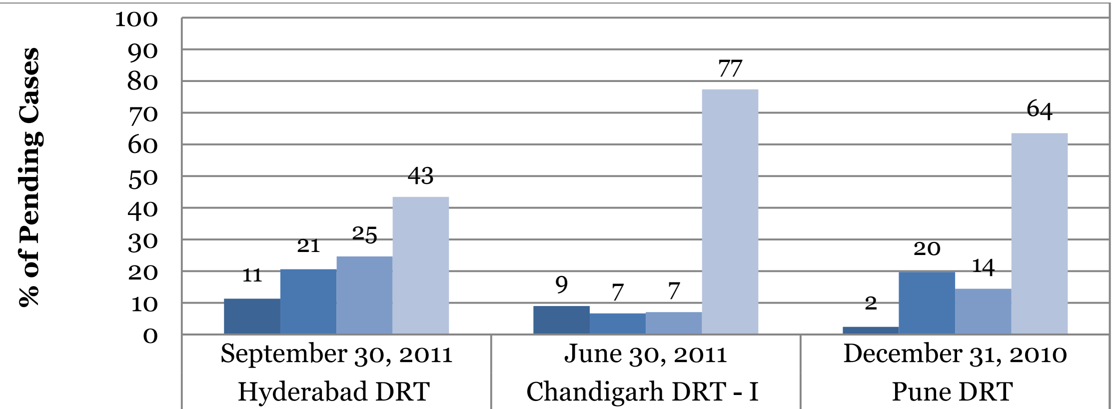
[100] Available at: *http://www.drat.tn.nic.in/Composition.htm*, last visited on March 10, 2015.
[101] Rule 5(5) of the DRT (Procedure) Rules, 1993.

*2.1.6. Inefficient recovery process*

The DRT Act empowers central government to provide DRT with one or more Recovery Officers (RO), as it may deem fit, in order to ensure recovery of due amount. Chapter V of the DRT Act describes the modes of recovery which could be employed by the RO, subsequent to order to that effect is passed by the PO.

During 2011-12, the Internal Audit Wing of Ministry of Finance undertook audits of 9 DRTs and 1 DRAT. The audit revealed huge pendency of recovery certificates before ROs of certain DRTs. In some cases, RCs were pending even for more than 5 years. On an average, around 60 percent of the RCs were pending for more than 3 years. Figure 4.5 provides a diagrammatic representation of the delay in recovery at ROs.

**Figure 4.5: Delay in Recovery at ROs**




| | September 30, 2011 Hyderabad DRT | June 30, 2011 Chandigarh DRT - I | December 31, 2010 Pune DRT |
|---|---|---|---|
| < 1 year | 11 | 9 | 2 |
| Between 1-2 years | 21 | 7 | 20 |
| Between 2-3 years | 25 | 7 | 14 |
| > 3 years | 43 | 77 | 64 |

In addition to long pending of RCs in above 3 RTs, 744 RCs (approximately 74 percent) out of total 999 RCs were pending before RO-I & II of Chandigarh DRT-II for more than 3 years as on March 31, 2011. Similarly, 1,009 RCs (involving total amount of ₹194.96 crore) were pending before RO-I & II of Patna DRT for more than 3 years as on July 27, 2011. This could be attributable to the absence of statutory provisions requiring ROs to recover the amounts at the earliest possibility.

Distinctly, it was also observed during the audit of Chandigarh DRT-I that nearly184 RCs were issued during the period 2008-2011 in which the recovery of ₹97.85 crore was involved. These cases were subsequently settled at a compromised amount of ₹34.08 crore. This seems not in conformity with the provisions of the DRT Act.[102] The Act empowers the POs to make necessary corrections in the RCs. However, the RO has no power to amend the RCs including compromising the amount of recovery at a lower amount. As a result, recovery of debts due to banks and financial institutions gets enormously affected.[103]

[102] Section 26 of the DRT Act, 1993.

[103] Report of Annual Review of the Internal Audit Wing, Ministry of Finance.

The DRT Act does not provide any indication of time period within which the RO must attempt recovery of amount due. Lack of indicative provisions, which require RO to employ best efforts to recover the amount at the earliest, often delays the recovery of due amount.

*2.1.7. Grant of several adjournments and irregular hearing of matters*

Section 19(5A) of the DRT Act provides that after hearing of the application has commenced, it shall be continued from day-to-day until the hearing is concluded. The DRT may grant adjournments if sufficient cause is shown, but no such adjournment can be granted more than three times to a party and where there are three or more parties, the total number of such adjournments cannot exceed six. In addition, the PO is authorised to grant such adjournments on imposing such costs as might be considered necessary.

This provision was inserted in the DRT Act pursuant to the 2012 amendment with the objective of reducing delays in recovery process. However, stakeholder consultations revealed that this is often not complied with and hearing of matters often suffers on account of multiple and unreasonable adjournments.

While the DRT is statutorily required to limit the number of adjournments and conduct day-to-day hearing, there is no corresponding provision in relation to DRAT. Consequently, a review of select matters pending at Chennai DRAT under the project revealed that the matters were adjourned without any significant work (trial failure) more than 60 percent of times, they were listed for hearing. Table 4.3 provides details in this regard.

**Table 4.3: Trial Failure in DRAT Chennai**

| S.No. | Name | Amount (₹ in Lakh) | Period tracked | No. of times listed | Trial failure |
|---|---|---|---|---|---|
| 1 | Moily Joseph v. PNB | 56.50 | July 2010 – December 2011 | 12 | 8 |
| 2 | S Geetha v. BoI | 4.00 | July 2010 – July 2013 | 20 | 15 |
| 3 | G Umashankar & anr v. ING Vysya Bank Ltd. | 11.21 | July 2010 - March 2013 | 20 | 13 |
| 4 | Praneeth Tobacco Company v. Central Bank | 13.00 | July 2010 – March 2012 | 11 | 7 |
| 5 | Precision Fastening v. State Bank of Mysore | 72.00 | September 2010 – May 2014 | 19 | 13 |
| 6 | Shakeel Ahmed I Kalghatgi v. A.O., SBI | 135.00 | October 2010 - March 2012 | 10 | 6 |
| 7 | Srinivasan v. The Indian Bank | 52.00 | October 2010 - March 2012 | 15 | 11 |
| 8 | M/s Rajendra Rice mill v. IOB | 130.00 | November 2010 - December 2014 | 36 | 23 |
| 9 | M/s Arunachaleswarar Mills & ors v. The A.O., Indian Bank | 356.00 | November 2010 - March 2013 | 26 | 16 |
| 10 | M/s Janata Sever And Cold Storage Pvt Ltd v. State | 390.00 | December 2010 - March 2013 | 26 | 15 |

| S.No. | Name | Amount (₹ in Lakh) | Period tracked | No. of times listed | Trial failure |
|---|---|---|---|---|---|
| | Bank of India & anr | | | | |
| 11 | K K Palanivelan v. The State Bank of India & ors | 1266.00 | December 2010 - July 2011 | 9 | 4 |
| 12 | S Purushothaman v. City Union Bank Ltd. | 97.00 | January 2011 - January 2012 | 11 | 5 |
| 13 | S Ravi & anr v. AO, ICICI Bank Ltd. | 20.00 | January 2011 - March 2012 | 12 | 5 |
| 14 | P Karnan v. A O, Vijaya Bank | 13.00 | February 2011- February 2015 | 28 | 18 |
| 15 | H S Gangadhar v. The Authorised officer, Indian Bank & ors | 207.00 | March 2011- February 2012 | 9 | 5 |
| 16 | N Santhanam v. A O, Punjab & Sind Bank & anr | 86.00 | May 2011- April 2013 | 18 | 12 |
| **Total** | | | | **282** | **176** |

The DRT Act is silent on action in case of non-compliance with Section 19(5A) and grant of multiple adjournments, beyond the number statutory prescribed. No costs are required to be statutorily imposed on the parties requesting adjournments, neither any adverse remark is required to be recorded against the PO granting excessive adjournments, thereby violating the provisions of the DRT Act. Absence of such penal provisions results in failure to comply with critical provisions of the DRT Act, resulting in defeating their purpose, and delaying the recovery process.

*2.1.8. Adoption of civil suit procedure*

The DRT is not bound by procedure laid down by the Code of Civil Procedure, 1908 (CPC), but can follow summary procedure to facilitate speedy recovery. The DRT is required to be guided by principles of natural justice and shall have powers to regulate their own procedure.

It must be noted that there is no specific provision under the DRT Act requiring the DRT to follow summary procedure. However, as POs are often skilled at, and used to the detailed procedure laid down by the CPC, Such procedure is followed at the DRTs also, defeating the purpose of establishment of DRTs as special purpose tribunals for speedy recovery of unpaid claims.

This was validated during stakeholder consultations as well wherein it was mentioned that at times detailed cross examination and investigation on evidence is carried out at DRT. Stakeholder consultations also revealed divergence of procedures amongst RTs, resulting in difficulties faced by litigants. A former General Manager in Recovery and Loan Department of a public sector bank pointed out that PO is, more often than not, a former district judge, who has an inherent tendency of granting stays/interim injunctions, because of which speedy disposal of matters cannot take place. Absence of statutory provisions to follow summary procedure at RTs results in delay in decision-making.

*2.1.9. Exercise of jurisdiction by other courts/authorities*

Section 18 of the DRT Act bars jurisdiction of any court or any other authority in relation to debt recovery matters covered by the DRT Act, other than writ jurisdiction exercised by High Court or Supreme Court under the Constitution of India.

It was revealed during stakeholder consultations that this provision is often overlooked by other civil and constitutional courts, which exercise jurisdiction and often pass adverse orders stalling the recovery process. The Supreme Court has often discouraged this practice and held that the High Courts should not interfere in the debt recovery proceedings until all alternatives available with the borrower are exhausted.[104] However, the situation seems not to have improved.

The stakeholders revealed that as soon as steps are taken under the DRT Act, the borrower approaches courts (high court or civil court), BIFR or even RTs to obtain interim injunctions/stay against the bank/financial institution. The stay once granted, is for an unlimited time and is extended at often unreasonable pretext. This results in delay in decision making, and consequent delay in recovery of the due amount.

The DRT Act does not provide any for any remedy in case other courts/authority exercise jurisdiction, despite such express prohibition. There is no express statutory provision expressly invalidating the proceedings at such other court/authority or consider such proceedings void *in abitio*. The DRT Act also does not levy any penalty or cost on the party approaching such other forum, and violating Section 18 of the DRT Act. Absence of provisions explaining consequences of violation of express prohibition under the Act could make such prohibitive provisions inconsequential and ineffective, resulting in delaying the decision making process.

*2.1.10. Sub-optimal procedure in relation to issue of summons*

The DRT Act provides that on receipt of application, the DRT shall issue summons requiring the defendant to show cause within 30 days of service of summons as to why relief prayed must not be granted.

However, the DRT Act is silent on the course of action in case the summons is returned unserved, even after multiple attempts. It was revealed during stakeholder consultations that defendants often refuse to accept the summons and at times due to change in address, causing delay in disposing of applications by DRTs.[105] The DRT Act does not specify what could be considered as 'reasonable attempt' to deliver summons, post which summons could be deemed to be served.[106] The DRT Act does not also specify the means of serving summon, neither any provisions with respect to deemed delivery of summons.[107]

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[104] In *United Bank of India vs. Satyawati Tondon and Ors.* III (2010) Banking Cases 495 (SC), the Supreme Court observes, '*….it is a matter of serious concern that despite repeated pronouncement of this Court, the High Courts continue to ignore the availability of statutory remedies under the DRT Act and SARFAESI Act and exercise jurisdiction under Article 226 for passing orders which have serious adverse impact on the right of banks and other financial institutions to recover their dues. We hope and trust that in future the High Courts will exercise their discretion in such matters with greater caution, care and circumspection'.*

[105] Asha Singh, *Performance of Non-Performing Assets (NPAs) in Indian Commercial Banks*, International Journal of Marketing, Financial Services & Management Research, 2013.

[106] The procedure for service of demand notice, as provided under Security Interest (Enforcement) Rules, 2002, issued under the Securitisation Act, may provide some guidance in this regard. Rule 3 states that where authorised officer has reason to believe that the borrower is avoiding the service of the notice or that for any other reason, the service cannot be made, the service shall be effected by affixing a copy of the demand notice on the outer door or some other conspicuous part of the house or building in which the borrower or his agent

While electronic means to deliver documents (including summons) might not be popular during enactment of the DRT Act, with passage of time electronic delivery of documents, through emails has become a norm. Consequently, failure of the DRT Act to recognise e-delivery as permissible mode of delivery of summon could have resulted in inordinate delays in carrying proceedings before the DRT. In addition, the DRT Act does not provide for imposition of cost or penalty in case of willful evading of summon by the concerned party.[108] Existence of sub-optimal provisions with respect to issue of summons has the potential to delay the debt recovery process.

*2.1.11. Inefficient provisions in relation to filing of written statement by defendant*

The DRT Act provides that the defendant shall, within a period of 30 days from the date of service of summons, present written statement of its defence, failing which, the PO may in exceptional cases and special circumstances in writing, allow not more than two extensions to the defendant to file the written statement.[109]

This provision was inserted pursuant to an amendment to the DRT Act in 2012,[110] and is a step in the right direction to ensure speedy decision making and consequent recovery of debt due. However, stakeholder consultations revealed that this is often not followed. Defendants have been given multiple extensions to file written statement.

There is no provision in the DRT Act, which spells out penalty or costs in case the provisions with respect to number or time period for extensions are not met. Absence of the provisions imposing costs on stakeholders, and adverse remarks against the PO, in case of non-compliance with provisions of DRT Act could make critical provisions of DRT Act ineffective and un-implementable and thereby delaying the decision-making process.

Moreover, the 2012 amendment neither provides any indication of the time period for which an extension could be granted, nor does it set out any upper time limit with respect to period of extension. Consequently, there might be situations in which the compliance with the DRT Act is observed in letter, but not in spirit. Adjournments for long periods, even if few, might defeat the purpose of the amendment and consequently delay the decision making.

### *2.2. Structural issues resulting in sub-optimal performance*

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ordinarily resides or carries on business or personally works for gain and also by publishing the contents of the demand notice in two leading newspapers, one in vernacular language, having sufficient circulation in that locality.

[107] However, it must be noted that the Regulations of Practice, 2010, for DRTs for the states of Maharashtra, Gujarat, Goa, and the Union Territories of Dadra and Nagar Haveli, Daman and Diu provide that summons or notice may also be served by e-mail, fax or courier with the leave of Registrar. Further, where a summons or the Notice is returned with postal remarks, such as ‘refused’, ‘unclaimed’, ‘not claimed’, ‘intimated’ or ‘intimation given’ it may be declared that the Summons or the Notice is served. In addition, where the Summons or the Notice properly addressed and properly issued is not received back within thirty days from the date of the posting, it may be declared, on submission of the Affidavit by the applicant regarding correctness of such address and evidence of posting that the Summons or the Notice is duly served. Similarly, where the Summons or the Notice is sent by e-mail or Fax at proper address, it may be declared, on an affidavit and proof of the delivery that it is duly served.

[108] Raju O.F., *‘Tribunals, a boom to bankers’,* available at: *http://www.thehindu.com/2000/06/15/stories/0615000j.htm*, last visited on March 10, 2015

[109] Section 19(5) of the DRT Act.

[110] This provision was not in the version introduced in the Lok Sabha, but was introduced later. Further, the DRT (Procedure) Rules, 1993, seem not to have been amended to showcase this change.

Delays might not be the only reason impeding the performance of the RTs and low recovery of dues. Other reasons for sub-par performance of RTs could be:

*2.2.1. Inadequate qualifications of PO and Chairperson and sub-optimal composition of RTs*
A person qualified to be a district judge is eligible to be appointed as a PO. Existing and former district judges are also qualified for the position.[111]A person not already in government service who has been an advocate/pleader for at least seven years, and is recommended by the High Court for appointment, is eligible for appointment as district judge.[112] Consequently, no specific skill set, other than practice of law, is prescribed to man special purpose tribunal like DRT.

Similarly, in relation to DRATs, a person qualified to be a judge of a High Court, or having experience as Grade I Indian Legal Services (ILS) Officer for three years is qualified to be appointment as Chairperson.[113] Like DRT, no specific set of skills is required to be appointed as Chairperson of a specific purpose appellate tribunal. Judges of High Court or Grade I ILS offices might not be adequately trained to handle complicated debt recovery matters, requiring technical expertise and exposure. Absence of adequate qualifications for POs and Chairpersons often delays the decision making, protracts the litigation (on account of multiple appeals), consequently, delaying the debt recovery. Stakeholders also mentioned that at times, POs are not able to understand the complexity of the matter, owing to limited expertise and experience, resulting in passing of sub-par orders, sans adequate reasoning. The Supreme Court has often frowned upon the practice of appointment of under-skilled personnel at tribunals like DRT.[114]

The government recently introduced the Tribunals, Appellate Tribunals and Other Authorities (Conditions of Service) Bill, 2014, which seeks to establish uniform conditions of service for the chairpersons and members of 26 tribunals and authorities, including DRAT.[115]

In addition, as discussed earlier, the RTs are manned by one person only. A review of practice at other tribunals and quasi-judicial bodies reveals that such bodies are usually manned by two members, viz. a legal and a technical, the latter being expert in the subject matter.[116]As a result of such expert members at other tribunals, the quality of decisions is usually high and the time taken to reach at the decision is usually less. For instance, the performance of Securities Appellate Tribunal (SAT) has been remarkable and most decisions are made within few months. Also, the decisions of SAT have adequate reasoning to enable the Supreme Court to decide one way or the other. There has never been any adverse observation against the SAT's functioning (judicial or administrative).[117]

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[111] Section 5 of the DRT Act.
[112] Article 233 of the Constitution of India.
[113] In addition to a PO having three years of experience. See Section 10 of the DRT Act.
[114] In Union of India v. R. Gandhi (dated May 11, 2010) the Supreme Court critisised the practice of appointing under-skilled persons to tribunals. It observed, '*what is a matter of concern is the gradual erosion of the independence of the judiciary, and shrinking of the space occupied by the Judiciary and gradual increase in the number of persons belonging to the civil service discharging functions and exercising jurisdiction which was previously exercised by the High Court. There is also a gradual dilution of the standards and qualification prescribed for persons to decide cases which were earlier being decided by the High Courts.*'
[115] Available at: *http://www.prsindia.org/uploads/media/Tribunal%20Authorities/Tribunal%20authorities%20bill,%202014.pdf*
[116] Such as Securities Appellate Tribunal and Income Tax Appellate Tribunal.
[117] See Somasekhar Sundaresan, '*SAT needs to be handled with care'*, available at: *http://www.business-standard.com/article/economy-policy/somasekhar-sundaresan-sat-needs-to-be-handled-with-care-112111200050_1.html*, last visited on March 10, 2015.

Consequently, sub-optimal composition of RTs has the potential to result in inefficient decision-making at RTs, procrastinating debt recovery.

*2.2.2. Inefficient appointment procedure for PO and Chairperson*

As per the rules for appointment of PO[118] and Chairperson,[119] the central government makes appointments to relevant posts on the basis of recommendations of a selection committee. The selection committee consists of:

- Chief Justice of India/Supreme Court Judge nominated by Chief Justice of India
- Secretary, Department of Economic Affairs, Ministry of Finance
- Secretary, Ministry of Law and Justice
- Governor, Reserve Bank of India/Deputy Governor nominated by Governor and
- Secretary/Additional Secretary, Department of Financial Services, Ministry of Finance

The selection committee is required to recommend persons from list of candidates prepared by the Ministry of Finance, and from the judges of the High Court nominated by the Chief Justice of such High Courts for appointment of Chairperson or the judicial officers nominated by a High Court for appointment of Presiding Officer.

As can be deduced from above, the selection committee is composed of judicial/government representatives, and does not have any independent experts in banking/debt recovery, to provide an impartial perspective. Lack of independent member in the selection increases the possibility of providing post-retirement benefits/sinecures to former government/judicial officers.[120] The Supreme Court has often critisised the selection process, which lacks independence and is biased towards the government.[121]

The structure of selection committee is quite divergent from the best practices, as recommended by expert committees, such as the Financial Sector Legislative Reforms Commission (FSLRC).[122] The sub-optimal selection process will throw-up under-qualified persons as PO and Chairpersons of RTs, thus compromising their performance.

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[118] DRT (Procedure for Appointment As Presiding Officer of the Tribunal) Rules, 1998.

[119] DRAT (Procedure for Appointment As Chairperson of the Appellate Tribunal) Rules, 1998.

[120] In Union of India v. R Gandhi, dated May 11, 2010, the Honourable Supreme Court came down heavily on the practice of providing sinecures to members of civil services, by appointments as members of Tribunals. The Supreme Court observes, '*.... in India, unfortunately Tribunals have not achieved full independence. The Secretary of the concerned 'sponsoring department' sits in the Selection Committee for appointment. When the Tribunals are formed, they are mostly dependant on their sponsoring department for funding, infrastructure and even space for functioning. The statutes constituting Tribunals routinely provide for members of civil services from the sponsoring departments becoming members of the Tribunal and continuing their lien with their parent cadre*'.

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[122] Supra note 5. Experts have recommended inclusion of expert members in selection committee for regulators.

And this is not enough. While the DRT Act grants wide discretion to the central government in relation to appointment of PO and Chairperson, the order of central government appointing any person as PO or Chairperson shall not be called in question in any manner.[123] Consequently, the central government might virtually appoint any person as it may deem fit to fill the position of PO and Chairperson, without any possibility of challenge of such order. As a result, there is a possibility that persons having limited knowledge/experience in relation to debt recovery might occupy the positions of PO or Chairperson, resulting in sub-optimal functioning of the RT.

*2.2.3. Absence of bonus malus[124] system for PO and Chairperson*

*Term of office not linked to the performance*: The DRT Act provides PO and Chairperson an unimpeded term of five years.[125] The law does not link the term to performance of PO. It also does not set out any performance indicators provided under the law, against which the performance of PO or Chairperson could be evaluated. This might result in creeping in of complacency and sub-optimal performance of PO and Chairperson. Absence of performance linked tenure has the possibility to result in sub-optimal functioning of PO/Chairperson, resulting in delays in deciding matters and thereby delaying the recovery.

In addition, the DRT Act does not provide any guidance or prohibit re-appointment of PO/ Chairperson. Possibility of re-appointment might affect independence in functioning. Without prejudice to the above, it might be argued that reappointment of PO/Chairperson could affect the independence in their functioning during the first term. The Supreme Court has recently pointed out that a provision for reappointment would constrain a member of a tribunal to decide matters in a manner that would ensure his reappointment.[126]

Moreover, a PO or Chairperson can be removed only on the grounds of proven misbehaviour or incapacity after the inquiry. There is no provision to censure/penalise/remove a PO or Chairperson, in case of non-performance/sub-optimal performance. The DRT Act does not even envisage initiation of inquiry in case allegations of non-performance are made against the PO or Chairperson. Absence of provisions that fix accountability of PO/Chairperson and link incentives to their performance have the potential to result in sub-optimal performance by such officers.

*No linkage of incentives to performance:* The DRT Act provides that salary, allowances, terms and conditions of service of the PO and Chairperson should be as might be prescribed by the central government. In addition, there is an express prohibition on variation of such salary, allowances, terms etc. to the disadvantage of PO/Chairperson, as the case might be, after appointment.

While Section 17A of the DRT Act empowers the Chairperson of a DRAT to appraise the work and record the annual confidential reports of POs of the DRTs under its jurisdiction, the DRT Act does not provide any indication to link the incentives, i.e. salary/allowances etc. to the performance of PO/Chairperson and there is no provision of disincentives in case of non-performance. In addition, the PO/Chairperson could be assured of favourable terms and

[123] Section 16 of the DRT Act.
[124] Incentive-disincentive.
[125] Unless having attained a specific age prior to completing such term.
[126] *Madras Bar Association vs. Union of India*, Transfer Case No. 150 of 2006, Supreme Court of India, September 25, 2014. The matter involved discussion on independence of members of the hitherto proposed National Tax Tribunal.

conditions throughout their tenure, as a result of an express prohibition to vary for disadvantage, even in case of underperformance. No linkage of performance to incentives could result in lack of motivation towards efficient performance.

*2.2.4. Absence of provisions to ensure adequate performance by staff of RTs*

*Recovery Officers (RO)*: The DRT Act empowers the central government to provide DRT with one or more RO, as it may deem fit. The salaries, allowances, terms and conditions of RO are prescribed by the central government. Neither there is requirement to ensure adequate number of ROs per DRT nor there any statutory requirement to review the performance of ROs. This has the possibility of appointment of inadequate number of ROs or sub-optimal functioning of ROs resulting in delaying the recovery process. In addition, the DRT Act does not require the central government to ensure that the salaries, allowances, etc. of the RO are linked to the amount of work and performance of the RO. This has the potential to result in sub-optimal performance at the ROs.

Further, the DRT Act is devoid of any general principle, which the central government must take into account while appointing or reviewing the performance of ROs appointed. Experts have pointed out in the past that ROs must have a judicial background.[127] The central government even agreed to give preference to only those candidates who have legal experience or hold a degree of law, include PO of the DRT in selection of ROs, and conduct regular training programmes for ROs along with Registrars/Assistant Registrars. This is to provide minimum working knowledge of the procedures followed in RTs, and the provisions of the DRT Act and SARFAESI Act along with rules made thereunder.[128] One is not certain if periodic training programmes are being conducted and if they are of appropriate quality. This is because the stakeholder consultations revealed that the performance of ROs have not seen much improvement.

*Registrars:* Registrars play an important role at the RTs. They are required to scrutinise applications/memorandum of an appeal as the case might be, for any defects, and register them after rectification of defects. Consequently, they are the first check point for matters filed at the RTs. In addition, Registrars are required to fix a date of hearing of application or other proceedings, issue notice thereof, dispose of matters relating to service of notice or other processes, etc. Carrying out these functions would usually require adequate knowledge and ample experience in practicing law.

However, existing qualifications[129] for appointment as Registrars might result in the appointment of persons without legal qualifications or limited experience in legal matters, to be appointed as Registrar. This might lead to sub-optimal performance and delays at Registrar-level.

*2.2.5. Lack of clarity on powers of RTs*

While the DRT have pecuniary jurisdiction in cases wherein the amount of debt due is more than ₹10 lakh, it does not seem to have express power to conclusively determine the amount of debt involved and is required to rely on documentary evidence presented. The DRT

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[127] Submissions of Amicus Curiae in the matter of Union of India vs. Debt recovery Tribunal Bar Association and Anr. dated January 22, 2013.

[128] Ibid.

[129] Office Memorandum dated issued 4 December 2014 issued by the Ministry of Finance, in relation to filing up vacancies at deputation basis at DRATs and DRTs, provides qualifications for Registrar as: government or state judicial service officers, scale v. officers of public sector banks, *et al.*

(Procedure) Rules, 1993 provide that every application must be accompanied by statement showing details of debt due, and documents relied on by the applicant.[130] Determination of facts in a DRT may be done by way of affidavits. In addition, a certified copy of entry in banker's book is regarded as *prima facie* evidence.[131]

The dispute in relation to amount of debt due would usually arise when (i) a borrower files its written statement to the summons issued by the DRT or (ii) an appeal is filed in DRAT and the borrower is required to deposit a portion of amount due (75 percent in case of matters under DRT Act and 50 percent in case of matters under Securitisation Act) or (iii) an application is filed against action by the lender under the Securitisation Act.

The DRT Act does not provide any clear indication with respect to the powers of RTs for conclusive determination of amount of debt due or the procedure till the time the amount of debt due is not determined. This has the potential to result in delays in decision making and consequently debt recovery.

*2.2.6. Existing of statutes overriding DRT Act*

Section 34 of the DRT Act provides it an overriding effect over any other legislation for the time being in force, save specified legislations. The legislations on which the DRT Act does not have overriding effect include the Industrial Finance Corporation Act, 1948; the State Financial Corporations Act, 1951; the Unit Trust of India Act, 1963; the Industrial Reconstruction Bank of India Act, 1984; the Sick Industrial Companies (Special Provisions) Act, 1985 and the Small Industries Development Bank of India Act, 1989.

Consequently, any proceedings under these legislations override the provisions of DRT Act. For instance, if a company is referred to the Board for Industrial and Financial Reconstruction (BIFR), then no proceedings can be taken under the DRT Act, delaying the recovery proceedings. This delays and disrupts recovery proceedings.

*2.2.7. Simultaneous proceedings under the DRT Act and the Securitisation Act*

Section 19 of the DRT Act allows the bank/financial institutions to withdraw the application made before made before DRT, with permission of such DRT Act, for the purpose of taking action under the Securitisation Act. This gives an impression that simultaneous proceedings under the DRT Act and Securitisation Act might not be possible and the proceedings under the DRT Act might have to be discontinued, for initiation of action under the Securitisation Act.

However, this could not have been the legislative intention as the objective of both the legislations is to facilitate speedy debt recovery. After conflicting decisions at various judicial forums,[132] the matter was settled by the Supreme Court in *Transcore v. Union of India*,[133]

[130] Rule 9 of the DRT (Procedure) Rules, 1993.

[131] Rule 12(8) of the DRT (Procedure) Rules, 1993 read with Section 4 of the Bankers' Book Evidence Act, 1891.

[132] Digivision Electronics v. Indian Bank 2005 (2) ISJ (Banking) 484, Indusind Bank v. Deva Tools, 2005 (2) 1 SJB 645, Sahir Shah v. Bank of India 11 (2006) BC 386, cited from G Ajith Kumar, *Security Interest Enforcement Action Under Securitisation Act – A Bird's Eye View,* RBI Legal News and Views (October-December), 2009.

[133] AIR 2007 SC 712.

which allowed simultaneous proceedings. However, the legislative provision remains unclear leaving the possibility of confusion in future.

*2.2.8. Absence on clarity on priority of creditors' claims*

While the DRT Act provides for different modes of debt recovery to the RO, such as attachment and sale of property, appointment of receiver for management of property, it does not provide for priority of creditors' claims, especially when the claims are secured, over other claims, such as statutory claims even when such claim arose subsequent to creation of charge in favour of secured creditor.

This might lead to a situation wherein the creditor is making efforts and deploying resources to recover the debt, however, when the amount is recovered, statutory claims[134] are required to be satisfied, prior to satisfaction of debt due to creditors.[135] This might result in creditors remaining short-changed.[136]

## 3. SARFAESI Act

As discussed in earlier chapters, the SARFAESI Act provides for several modes to banks/ financial institutions for enforcing their security interest. It envisaged the use of such modes without intervention of courts or judicial authorities, thereby avoiding delays hitherto been experienced in (judiciary led) recovery process. The SARFAESI Act was intentionally drafted to serve the needs of lenders, with reasonable due process protection to borrowers.[137] However, evidence suggests that SARFAESI Act has not been able to meet the expectations. The ratio of amount recovered (to the total amount involved) has been steadily decreasing. In fiscal 2012-13, this ratio was 27.1 percent, which reduced to 25.8 percent the following year. In absolute terms, the amount remained unrecovered increased from ₹496bn to ₹702bn, during the given period.[138]

SARFAESI Act has not been able to achieve its objectives as: its provisions leave scope of delay in recovery; the modes prescribed remained inefficient; provisions, or absence of provisions, otherwise impede debt recovery. Table 4.4 provides a snapshot of such issues, and following sub-sections discuss the same in detail.

**Table 4.4: Issues Relating to SARFAESI Act**

| Issues relating to delay in recovery | Issues relating to sub-optimal modes | Miscellaneous issues impeding recovery |
|---|---|---|

[134] Such as taxation dues.

[135] It must be noted that pursuant to the Finance Act, 2011, the claims of the secured creditors under the DRT Act and the SARFAESI Act, have been provided priority over tax dues under the Customs Act, 1962, Central Excise Act, 1944 and the Finance Act, 1994 relating to service tax.

[136] The Committee on Financial Sector Assessment (CFSA) suggests that the law should be amended to the effect that the priority of charge for state dues should not operate in respect of prior mortgages created in favour of the secured creditors.

[137] *Mardia Chemicals v. Union of India* 2004 (4) SCC 311.

[138] Statistical Tables Relating to Banks in India, *Table 19: NPAs of scheduled commercial banks recovered through various channels*, December 2014.

| | | |
|---|---|---|
| • Absence of time period within which Magistrate should take possession of the secured asset<br>• Wide scope of challenge of measures taken under SARFAESI Act at the DRT<br>• No accountability in case application is not disposed of within prescribed period<br>• Possibility to challenge transfer of financial asset<br>• No clarity on simultaneous proceedings with DRT Act<br>• Exercise of jurisdiction by civil/other court | • Taking over of management by secured creditor for a limited time<br>• Lack of clarity on process of taking over of possession, when actual possession is with third party<br>• No priority to claims of secured creditors<br>• No definition of agriculture land<br>• No guidance on determination of correct valuation of security<br>• Sub-optimal feature of securitisation and asset reconstruction process | • Possibility of discretionary application of SARFAESI Act<br>• Excessive powers to RBI<br>• Sub-optimal procedure regarding registration of claims<br>• Lack of competitive neutrality amongst financial institutions |

### *3.1. Issues relating to delay in recovery*

*3.1.1. Absence of time period within which the Magistrate should take possession of the secured asset*

Section 14 of the Securitisation Act requires the secured creditor to make an application to the Chief Metropolitan Magistrate (CMM) or District Magistrate (DM), as the case may be, for assistance in taking possession or control of secured asset. The CMM/DM may take possession, or authorise any officer subordinate to it to take possession, and for the purpose of which it may take such steps as may be necessary.

Section 14 fails to specify any time period within which the direction, steps and consequent possession must be taken, and the time within which possession must be transferred to the secured creditor. This could delay the recovery process.[139]

It was revealed during stakeholder consultations that when possession of the secured asset is to be taken in areas other than cities, the secured creditor has to approach the District Magistrate, who is also the District Collector (DC). The DM/DC is invariably unavailable to attend to these matters due to their preoccupation with other duties, leading to inordinate delays.[140]

In addition, there is a lack of clarity on the powers of DM/CMM. While there have been various judicial pronouncements in the past holding that they are merely executive in nature,

[139] The Report of Working Group on Banking (2013) notes, '*Section 14 of SARFAESI (2002) is silent on the time period within which petitions are required to be disposed of by the Chief Metropolitan Magistrate or District Magistrates. Since no time lines are prescribed, these petitions take longer than required to be disposed of leading to unnecessary delays. The Bombay High Court, noting the significant delay caused in enforcing security interests under Section 14 petitions, prescribed a time line of two months for all petitions filed under Section 14*'.

[140] F M Alexander, *Timeframes for disposal of cases*, Economic Times, May 12, 2010.

the Supreme Court in the matter of *Harshad Govardhan v. IARC*[141], held that DM has certain substantial powers, as well.[142] This has the potential to delay the recovery proceedings.

*3.1.2***.** *Wide scope to challenge measures taken under SARFAESI Act at DRT*

Under Section 17 of the Securitisation Act, any person aggrieved by modes adopted by a secured creditor[143] to recover its secured debt, can make an application to the relevant DRT, for passing of appropriate orders.[144] This Section has very wide scope, without adequate checks and balances, as described below.

*No justification needed:* There is no indication of the grounds on which a challenge could be made to the action under Section 13(4) of the Securitisation Act. The applicant is not expressly required to substantiate or justify or provide evidence of any injury for making a challenge under Section 17. Further, there is no provision for imposition of costs on the applicant in case of unjustifiable challenge. For instance, it was revealed during stakeholder consultations that in case challenge is on low reserve price for sale of assets, the applicant is not required to submit documents from prospective bidder for a price higher than the reserve price set by the secured creditor. Such unbridled power to challenge the measures under SARFAESI Act without any sufficient justification delays the recovery process.

*No pre-requisite for filing application:* There is no pre-requisite for making an application under Section 17 of the Securitisation Act. For instance, unless the borrower is disputing its status as a borrower and consequently disputing the amount payable to the secured creditor, by making an application under Section 17, it is merely alleging non-compliance with procedure under Section 13(4), and not the fact of its responsibility to pay the due amount. Despite this, the borrower is not required to deposit any sum with the DRT (other than the application fee) to make an application. Such unrestricted power often delays the recovery process.

While an appeal to DRAT from an order of DRT is not allowed unless the borrower has deposited with DRAT 50 percent of the amount of debt due, which could be reduced to not less than 25 percent by the DRAT, for the reasons to be recorded in writing,[145] there is no corresponding provision when an application is filed at DRT by the borrower, resulting in delays in recovery of due amount.

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[141] MANU/SC/0377/2014.

[142] Such as, to determine the legality of tenancy.

[143] Under Section 13(4).

[144] In the case of *Authorised Officer, Indian Overseas Bank v. Ashok Saw Mills* (2010), it was observed that, "*intention of the legislature is, therefore, clear that while the Banks and Financial institutions have been vested with stringent powers for recovery of their dues, safeguards have also been provided for rectifying any error or wrongful use of such powers by vesting the DRT with authority after conducting an adjudication into the matter to declare any such action invalid and also to restore possession even though possession might have been made over to the transferee. The consequences of the authority vested in DRT under subsection (3) of Section 17 necessarily implies that the DRT is entitled to question the action taken by the secured creditor and the transactions entered into by virtue of Section 13 (4) of the Act. The Legislature by including subsection (3) in Section 17 has gone to the extent of vesting the DRT with authority to even set aside a transaction including sale and to restore possession to the borrower in appropriate cases*".

[145] Section 18 of the Securitisation Act. It has often been contented that determination of debt should precede the power of DRAT to direct depositing of part of the amount due. This was negated in *Forum Diamonds v. Bank of Baroda* 2010(1) DRTC 345 Bombay (DB) wherein the court held that if such contention was accepted, the very purpose of SARFAESI Act would be defeated. Also see, Diwakars Law Page, *Important case laws on Securitisation Act*, December 16, 2010.

*Injunction against secured creditors' action:* Stakeholder consultations revealed that when an application under Section 17 is pending before the DRT, more often than not, DRT orders suspension of action taken by secured creditor under Section 13(4) of the Securitisation Act, resulting in delay in recovery of the due amount.[146] The Securitisation Act does not provide any guidance with respect to the time period for which such suspension can continue. Unrestrained injunctions also result in delays in recovery.

*No penal provision in case of fraudulent application:* The Securitisation Act does not provide for imposition of any penalty/ fine on any person filing frivolous application under Section 17. There is no provision for compensating the secured creditor in case of delay on account of filing of frivolous applications under Section 17.[147] This could result in filing of frivolous applications, resulting in delay in recovering the due amount.

*3.1.3. No accountability in case application is not disposed of by DRT and DRAT within prescribed period*

The Securitisation Act provides that an application made under Section 17 shall be dealt with by the DRT as expeditiously as possible and disposed of within 60 days from the date of such application. Section 17 further provides that the DRT from time to time might extend the said period for reasons to be recorded in writing. However, the total period of pendency of the application with the DRT shall not exceed four months from the date of making of such application. If the application is not disposed of by the DRT within a period of four months, any party to the application may make an application to the DRAT for directing the DRT for expeditious disposal of the application. However, such direction by DRAT does not seem to be binding on DRT, owing to lack of explanation of the term 'expeditious disposal'.

Further, Securitisation Act does not provide for any accountability provision should such statutory prescriptions in relation to time period are not complied. This often delays the recovery process, as validated by interactions with stakeholders.[148]

As indicated in Table 4.3**,** under the project, select cases relating to SARFAESI Act, pending at DRAT Chennai were analysed. The analysis reveals that the matters in relation to SARFAESI, as indicated in the Table 4.5 have been pending for long duration mostly on account of delay in settlement and non-appearance of parties:

**Table 4.5: Pendency of Securitisation Matters at Chennai DRAT**

| Matter | Period of pendency | Reason for the delay |
|---|---|---|
| Moily Joseph v. PNB | July 2010- | Delay in conclusion of settlement talks |

[146] R Gandhi, *Banks, Debt Recovery and Regulations: A Synergy*, Feb 10, 2015, wherein it was noted, "*It is understood that in a number of cases, DRT grants time to borrower/applicant to make payment and subject to payment, bank's SARFAESI action is stayed and matter lingers on for a long period*".

[147] For instance, Section 19 of the Securitisation Act provides that in case the DRT or DRAT holds that possession of secured assets by the secured creditor is not in accordance with Securitisation Act, and directs secured creditors to return such secured assets to the concerned borrowers, such borrower shall be entitled to the payment of such compensation and costs as might be determined by such Tribunal. However, the Securitisation Act is devoid of any corresponding provision for the benefit of secured creditor in case of delay in recovery of amount due in case DRT or DRAT dismisses as the application as frivolous in nature.

[148] R Gandhi, *Banks, Debt Recovery and Regulations: A Synergy*, February 10, 2015, '*though Section 17 (5) provides that an application under Section 17 shall be disposed of within 60 days of date of application (extendable up to 4 months) the said time frame is not being strictly followed in practice. There is long delay in passing orders by the DRTs*'

| Matter | Period of pendency | Reason for the delay |
|---|---|---|
| | December 2011 | |
| S Geetha v. AO | July 2010- July 2013 | Delay in conclusion of settlement talks |
| G Umashankar v. ING Vyasa | July 03, 2010 - March 2013 months | No representation from parties |
| Precision fasting v. State Bank of Mysore | September 2010- May 2014 | No representation from parties |
| Arunachaleshwar Mills v. Indian bank | November 2010- March 2013 | Delay in conclusion of settlement talks and no representation from parties |

The situation is not unique to Chennai DRAT and many DRTs across the country, specifically, Chandigarh DRT, Lucknow DRT and Jaipur DRT are facing similar delays in disposing of securitisation applications, as revealed by analysis undertaken under the project. Such long pendency of securitisation applications at DRT frustrates the purpose of recovery measures granted to secured creditor under Securitisation Act. This also results in delay in disposing of applications by RTs causing in delays in recovery of due amount.

In addition, a review of proceedings at DRAT Chennai revealed that out of 444 hearings during the month of October 2014, 150 (around 34 percent) related to Securitisation Act. Similarly, an analysis of matters pending at DRT-1 Chennai and DRT Coimbatore reveals that securitisation matters comprise approximately half of the pendency. Pendency of large number of securitisation matters at RTs has been corroborated by a study conducted by Centre for Public Policy Research in 2010, which revealed the following information given in Table 4.6 with respect to Ernakulum DRT[149]:

**Table 4.6: Securitisation Applications Pending at Ernakulum DRT**

| | |
|---|---|
| Total number of securitisation applications filed in 2010 | 730 |
| Total number of securitisation applications disposed of in 2010 | 287 |
| Percentage of securitisation applications disposed of in 2010 | 39.31 |

The study further found that since the establishment of the Debt Recovery Tribunal in Kerala, 2,031 securitisation applications have been filed up to December 2010. It estimated that of these, the number of SAs still pending could be between 1,200 and 1,300, or close to 60 percent. This reveals the unfortunate state of affairs under the SARFAESI Act, wherein, armed with strong powers, the secured creditors are not able to recover the due amounts. One of the significant reasons for this is the absence of accountability provisions resulting in cases not being disposed of by DRTs within the prescribed time frame.

*3.1.4. Possibility to challenge transfer of financial asset*

The Securitisation Act authorise transfer of financial assets from secured creditors to Securitisation or Reconstruction companies. Under Section 5(5) of the Securitisation Act, SC/RCs might with the consent of the secured creditor, file an application before the RT for the purpose of substitution for its name in any pending suit, appeal or other proceedings.

[149] Mukund P Unny, *A Study on the Effectiveness of Remedies Available for Banks in a DRT – A case study on Ernakulum DRT*, Centre for Public Policy Research, February 2011.

However, the Section does not prohibit challenge of transfer/assignment[150] or prevent DRT from looking into validity of transfer/assignment. Assignment does not change the adversely impact rights of borrower in any manner. Absence of such express prohibition has the potential of being misused and thus delaying the recovery process.

*3.1.5. No clarity on simultaneous proceedings under DRT Act and Securitisation Act*

Section 13(10) of the Securitisation Act provides an impression that application before DRT can be filed by a secured creditor only where its dues are not fully satisfied with sale proceeds of the secured assets. This could not have been legislative intention, as that would have stifled the purpose of debt recovery. While the Supreme Court, in the matter of *Transcore v. Union of India*[151] held that withdrawal of application pending before RT is not a precondition for taking action under Securitisation Act, and it was for the bank/financial institution to exercise its discretion as to cases in which it might apply for leave and in cases where they might not apply for leave to withdraw, stakeholder consultations revealed that this provision has often being misused by non-genuine borrowers to stifle the recovery proceedings.

*3.1.6. Exercise of jurisdiction by other judicial foras*

Section 34 of the Securitisation Act bars civil courts from entertaining any suit or proceeding in respect of any matter which a RT is empowered to determine. Further, no injunction can be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under the Securitisation Act or DRT Act.

However, the legislation fails to prescribe consequences of entertaining suit, or grant of injunction, by civil courts or any other court, contrary to provisions of the Securitisation Act.[152] Absence of provisions specifying accountability/adverse consequences in case of violation of provisions of the Securitisation Act make its provisions ineffective, and inconsequential.

Such concerns have been validated by stakeholder interactions wherein it was pointed out that civil courts, high courts and other judicial forums often ignore the provisions of the Securitisation Act and exercise jurisdiction, passing orders that have adverse impact on the rights of banks and financial institutions.[153]

***3.2. Issues relating to sub-optimal modes of recovery***

*3.2.1. Taking over of management by secured creditor for a limited time period*

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[150] Ministry of Finance, *Report of the Key Advisory Group on the Asset Reconstruction Companies*, 30 December 2011.

[151] 2006 (12) SCALE 585.

[152] While the Supreme Court in the matter of *Union of India vs. Satyawati Tondon and Ors*, (order dated 26 July 2010) has held that the High Courts should not interfere in the debt recovery proceedings before all alternatives available with the borrower are exhausted.

[153] In *United Bank of India Vs Satyawati Tondon* and others (2010 (2) DRTC 457 (SC)) the Supreme Court observed, "that it is a matter of serious concern that despite repeated pronouncement of the Supreme Court, the High Courts continue to ignore the availability of statutory remedies under the DRT Act and SARFAESI Act and exercise jurisdiction under Article 226 for passing orders, which have serious adverse impact on the right of banks and other financial institutions to recover their dues. We hope and trust that in future the High Courts will exercise their discretion in such matters with greater caution, care and circumspection".

Section 15(4) of the Securitisation Act allows the secured creditor to take over management of borrower's business for the purpose of recovery of debt. The Section further requires a secured creditor to restore the management of business to the borrower upon realisation of its debt in full. The intention of such provisions seems to prevent unjust enrichment of secured creditor.

However, it must be realised that it is the duty of borrower to manage its business efficiently, and repay the debt due to the secured creditor. The secured creditor will be required to put in additional efforts and resources to turn around the business of the borrower from which the borrower will be benefitted as it gets back management of the business in a healthy state. The secured creditor will not benefit from putting in any additional efforts, save recovering the original debt, repaying which was the responsibility of the borrower. Such sub-optimal provisions often make the measures available for debt recovery unattractive. This was validated during stakeholder consultations, as it was mentioned that stakeholders do not prefer recovery through use of this mode. This has also resulted in limited expertise amongst stakeholders in taking over and turning around of management of borrowers.

*3.2.2. Lack of clarity on process of taking over of possession, when actual possession is with third party*

While the Securitisation Act allows secured creditors to recover debt by speedily taking possession of secured assets and affecting its transfer, there might be situations wherein the secured assets are already in possession of third parties, claiming interest in the secured assets, such as, tenants. In such cases, a difficulty might arise should the secured creditor require actual possession of the property.[154] In addition, it has been often argued that Securitisation Act provides for power to take symbolic possession and not actual possession.[155]

Absence of statutory clarity on tenant rights, differentiation between rights created after the initiation of securitisation proceedings, and power to take actual possession, often delays the recovery of debt.

*3.2.3. Requirement for consent of borrower for sale of moveable property*

The Security Interest (Enforcement) Rules, 2002 provides that sale of moveable property/ security by any method other than public auction or public tender shall be on such terms as may be settled by parties in writing. It is not clear if consent of the borrower is required to sell moveable property by a private treaty. In the matter of *J Rajiv Subramaniam v. Pandian*[156], it was held that that in case of sale by private treaty, there needs to be consent of

[154] The issue whether tenancy created after the mortgage but before the issue of notice under Section 13(2) is binding on secured creditor was examined in *Business India Builders & Developers v. Union of India,* wherein the Kerala High Court held that the combined effect of Section 35 and 37 overrides Rent Control Act, disregarding the need for eviction proceedings to evict tenants. However, a contrary view was taken by DRAT Mumbai in *Shikshak Sahakari Bank Limited v. Indian Oil Corporation Limited*, where in it was held that the bank can step into the shoes of mortgagor and cannot evict the respondent without initiating eviction proceedings under the Transfer of Property Act or the Rent Control Act. Cited from G Ajith Kumar, *Security Interest Enforcement Action under Securitisation Act – A Bird's Eye View,* RBI Legal News and Views (October-December), 2009.

[155] In case of *Transcore v. Union of India* (2006 (12) SCALE 585), the Supreme Court clarified that the authorised officer has the right to take actual as well as symbolic possession and there is no dichotomy between the two.

[156] MANU/SC/0217/2014.

the defaulter. This makes the sale by private treaty very difficult, costly, time consuming and hinders the debt recovery process.

*3.2.4. Absence of priority of secured creditor claims*

The Securitisation Act does not provide priority to the charge of secured creditor, over other claims, such as statutory claims,[157] even when such statutory claim arose subsequent to creation of charge in favour of the secured creditor.

This might lead to a situation wherein the secured creditor is making efforts and deploying resources to recover the debt, however, when the amount is recovered, statutory claims are required to be satisfied, prior to satisfaction of debt due to secured creditors.[158] This might result in secured creditors remaining short-changed.

Stakeholder consultations revealed that above was often the case. It was recalled that there have been cases where entire amount recovered by a bank was directed to be deposited in government treasury.[159]

Further, crown debt has historically been given first preference in laws of many countries, even though these dues were unsecured. Priority has been given to government tax claims to protect public revenue. However, in recent times, there is a global trend to reduce tax priorities. Countries such as Australia, UK, and Germany have eliminated all tax priorities, whereas in Canada they have eliminated all but withholding taxes. This trend is based on the view that the government does not need revenue at the expense of other creditors and can make up for its position as an involuntary creditor by using special collection tools at its disposal.[160]

*3.2.5. No definition of agriculture land*

The Securitisation Act is not applicable to any security interested created in agriculture land. However, it does not define the term 'agriculture land'. It is not clear if the revenue records would have primacy over the current use and condition of the property, and there have been conflicting decisions by adjudicatory authorities on this issue.[161] Lack of clarity encourages litigation and prolongs the recovery of the debt.

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[157] Sales tax legislations in states like Rajasthan, Kerala and Maharashtra have provisions giving priority to states under such statutes. In *Central Bank of India v. State of Kerala* (decision dated February 27, 2009), the Supreme Court upheld validity of such statutory provisions. See, G Ajith Kumar, *Security Interest Enforcement Action under Securitisation Act – A Bird's Eye View,* RBI Legal News and Views (October-December), 2009. In addition, in the matter of Bank of India v. Assistant Provident Commissioner, it has been held that dues under EPF will have priority over dues of the secured creditor.

[158] It must be noted that pursuant to the Finance Act, 2011, the claims of the secured creditors under the DRT Act and the SARFAESI Act, have been provided priority over tax dues under the Customs Act, 1962, Central Excise Act, 1944 and the Finance Act, 1994 relating to service tax. However, absence of specific provision in the SARFAESI Act in relation to creating first charge in favour of the bank gives provisions of Section 281(b) of the Income Tax Act, 1961 read with Rule 16 of the Second Schedule of the Income Tax Act, 1961 overriding effect over the provisions of SARFAESI Act, see the Gujarat High Court decision in the case of UCO Bank vs. UOI (182 Taxman 26).

[159] M R Umarji, *Prioritise secured creditors claims*, Economic Times, May 12, 2010.

[160] Report of Working Group on Banking, 2013, referring to International Insolvency Institute, 2005.

[161] G Ajith Kumar, *Security Interest Enforcement Action Under Securitisation Act – A Bird's Eye View,* RBI Legal News and Views (October-December), 2009. In the matter of Gajula Exim (P) Ltd. v. Authorised Officer, Andhra Bank it was held that the borrower failed to prove that any agricultural operations were being conducted in any part of the land under consideration. It was held that mere paying Land Revenue cannot be treated as agricultural property.

*3.2.6. Absence of provisions to determine correct valuation of the security*

The Securitisation Act allows acquisition of rights or interest in financial assets by a securitisation company or a reconstruction company from a bank or financial institution.[162] The terms and conditions of the sale are required to be agreed between the parties, and there are no guiding principles in this regard under the Securitisation Act.

Moreover, there is no provision in the Securitisation Act allowing transfer of rights or interest in financial assets by a securitisation/reconstruction company to other.[163] Such arrangement handicaps the securitisation/reconstruction company and prevents price discovery of the stressed assets,[164] consequently resulting in sub-optimal returns from the securitisation and reconstruction company for the bank/financial institution as well as the borrower.

Stakeholder consultations revealed that there have been concerns in relation to ARCs purchasing assets at low price and eventually selling them to original promoters or their related parties, on beneficial terms. This seems to be on account of lack of statutory provisions mandating adequate valuation and transparency of assets.[165]

*3.2.7. Sub-optimal securitisation and asset reconstruction process*

*Problems faced by lenders:* The stakeholder consultations revealed that majority of sales of secured assets to SC/RCs have been on the basis of issue of security receipts (SRs). Lender banks hold over 80 percent of the SRs, resulting in limited transfer of risk.[166] In this form of the sale transaction, the NPA risk remains in the bank balance sheets – it is merely being reclassified as investment in SRs. Further, there is little improvement in the overall economic efficiency in resolution of NPAs. Consequently, the securitisation model has been proving to be sub-optimal and inefficient.

In recent past, the annual management fee of ARCs (typically around 1.5-2 percent of the acquisition value of the asset) had no linkages with the recovery from the asset. Hence, ARC had little incentive to recover or resolve assets. They just needed to hold the assets till maturity of the SRs, during which they continue to earn the management fee income. However, with some recent regulatory changes, the situation seems to be improving a bit.[167]

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[162] Section 5.

[163] RBI Circular, *Acquisition of Financial Assets by Securitisation/ Reconstruction Companies – Clarifications*, April 22, 2009. The Working Group on Banking (2013) notes that while such a provision is useful in preventing cartels amongst the asset reconstruction companies, it also prohibits such companies from cooperating with each other and offering a competitive price in an auction. Other experts (see *http://www.iica.in/images/sarfaesi_papers.pdf*), are of the view that, presumably, this was done so as to block the possibility of a group of ARCs indulging in a ponzi operation by going on transferring an asset from one to another, in a circular way, without making much recovery. Such circular transfers from one ARC to another would defeat the very purpose for which ARCs were set up – which was to realise value from the NPAs acquired from banks, within a period of five years. But the remedy – de-notifying ARC as a financial institution so that an ARC can acquire NPAs from a bank or financial institution but not from another ARC – has turned out to be worse than the disease. For, it has blocked the transfer of assets between one ARC and another even for a legitimate purpose.

[164] RBI Discussion Paper, *Early Recognition of Financial Distress, Prompt steps for Resolution, Prompt Sales for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distress Assets in Economy*, December 17, 2013.

[165] Indian banks and NPAs - IV: SARFAESI Act and its impact, MoneyLife, July 16, 2012.

[166] Credit Suisse, *Indian Financial Sector, Distressed asset recovery: A reality check*, Equity Research, April 30, 2014.

[167] Ajay Shah *et al*, NPAs processed by asset reconstruction companies – where did we go wrong? August 23, 2014.

However, the securitisation model has been to be costly and sub-optimal for lenders, on account of hefty up-front fee, and sub-optimal returns on investment.

*Problems faced by ARCs:* Stakeholders revealed that there were a variety of procedural problems with the process of banks selling NPAs including auctions. These include inadequate time for due diligence by ARCs, and auctions that are cancelled after bids are received.

Besides, it was mentioned that a company in distress needs funds for reviving itself but, as a matter of policy, banks do not infuse fresh funds in an NPA case. An ARC can, and if wants to but is not allowed to do so – unless it acquires at least a part of the NPA first (which is not feasible if banks do not want to sell) – even though entities like private equity fund are allowed to do so. As a result, ARCs cannot contribute to reviving distressed cases. Further, in cases of rehabilitation/ revival or take-over of management under Section 9(a) of SARFAESI Act, an ARC would invariably need to infuse fresh funds in the company. If, after fresh funds have been infused, a statutory authority serves an order on the borrower company impounding all or a part of the cash available (which might have either been generated from operations or resulted from fresh infusion of funds by way of debt or equity by the ARC) or attaching its assets in order to realise any past dues, it would not only jeopardise the company's revival but would also put at risk the new funding arranged by the ARC.[168] Consequently, the securitisation/asset reconstruction model has proven to be complicated and sub-optimal for ARCs as well.

### *3.3. Other issues impeding debt recovery*

*3.3.1. Excessive powers to the RBI*

Section 12 of the Securitisation Act gives powers to the RBI to determine policy and issue directions in public interest, or to regulate financial system of the country to its advantage or to prevent the affairs of any securitisation company or reconstruction company from being conducted in a manner detrimental to the interest of investors or in any manner prejudicial to the interest of such securitisation company or reconstruction company.

These are very wide powers without any guidance in relation to usage, and thus capable of being misused. Existence and usage of such powers without necessary justification and accountability mechanisms has the potential to impose unjustifiable costs on stakeholders.

*3.3.2. Discretionary application of Securitisation Act*

The central government may, by way of a notification in public interest, direct that any of the provisions of the Securitisation Act shall /shall not apply to such class or classes of banks or financial institutions, with such exceptions, modifications and adaptations as may be specified in the notification.[169]

However, there is no statutory requirement to provide rationale and justification of such action. Grant of such discretionary powers to the central government without consequent accountability provisions might result in abuse of discretion.

*3.3.3. Sub-optimal provisions regarding registration of security interests*

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[168] Rajiv Ranjan, *SARFAESI Act 2002 and the Role of Asset Reconstruction: Seminar on Corporate Rescue and Insolvency,* September 10, 2010.
[169] Section 31A of the Securitisation Act.

The Central Registry, as envisaged under the Securitisation Act, was operationalised in March 2011,[170] to enable registration of security interests. The Securitisation Act while providing for mandatory registration does not provide priority to security interests on the basis of date of registration.[171]

The particulars of every transaction of securitisation, asset reconstruction or creation of security interest are required to be filed on payment of fee, within thirty days, by the SC/RC secured creditor, as the case might be. The SC/RC secured creditors are also statutorily required to report modification/satisfaction of security interest. Any default in filing of registration, modification or satisfaction of security interest is punishable with fine up to ₹5000 per day of default.[172]

The Central Registry Rules have currently been implemented only in case of equitable mortgages.[173] The stakeholder consultations revealed that, once the provisions are fully implemented, on any given business day, lots of security interests might be modified or get satisfied. All of these will need to be registered by the bank with the Central Registry. Failure to do so will attract a fine of up to ₹5,000 every day. One will have to think if banks will be able to handle the magnitude, or be in a position to pay the penal charges.[174]

This provision is inspired by Article 9 of the Uniform Commercial Code of USA, which provides for registration of security interests, and provides priority to security interests based on the date of registration. Consequently, the stakeholders revealed that internationally, the perceived benefit of central registration is to enable searching of security interests, so that a lender, wanting to give a loan against an asset, may search whether a security interest already exists. If a security interest is not registered on an asset, a lender might presume the asset is free from security interests. This benefit does not apply to India, as the Securitisation Act provides that the non-filing of security interest will not affect priority. This would mean, a lender might have obtained security interest, and not filed it, and yet claim priority over a second lender who would have searched the Central Registry, not found the charge, and hence, went ahead and sanctioned a loan on the same asset. If the fact of non-registration does not affect the validity or priority of a security interest then the very reliability of the searching process gets negated.[175]

*3.3.4. Lack of competitive neutrality amongst financial institutions*

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[170] SARFAESI (Central Registry) Rules, available at *http://rbidocs.rbi.org.in/rdocs/Content/PDFs/CERR250411.pdf*

[171] Section 20(4) provides that provisions of SARFAESI Act pertaining to Central Registry shall be in addition to and not in derogation of any of the provisions contained in other laws requiring registration of charges and shall not affect the priority of charges or validity thereof under those Acts or laws.

[172] Section 27 of the Securitisation Act.

[173] Stakeholder consultations revealed that it is difficult to understand as to why equitable mortgages had to be distinguished. An RBI Press Release (dated April 21, 2011, DBOD. Leg. No. BC. 86/09.08.011 /201011) provides that this has been done to prevent frauds. In fact, the chances of frauds are minimal in case of equitable mortgages, as the title deeds are physically with the lender. If the title deeds are indeed fabricated, then the Central Registry does not help at all, because registration of such mortgage does not validate what is actually invalid.

[174] Vinod Kothari, *Futile Central Registry Rules impose a heavy burden on banks*, Moneylife, April 30, 2011

[175] Vinod Kothari, *Futile Central Registry Rules impose a heavy burden on banks*, Moneylife, April 30, 2011

Benefits of debt recovery under Securitisation Act have been accorded to banks and notified financial institutions.[176] Non-bank finance companies have not been notified as yet. This creates an uneven playing field and handicaps the NBFCs, which have recourse of limited recovery options. An amendment in this regard has been proposed in the Union Budget 2015-16.[177]

Having understood the baseline and the prevailing scenario with respect to the DRT Act and the Securitisation Act in detail under this chapter, the subsequent chapters will delve on the cost of the baseline scenario, possible legislative alternatives and costs and benefits thereof.

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[176] Section 2(m)

[177] The Union Budget 2015-16 document notes, '*To bring parity in regulation of Non-Banking Financial Companies (NBFCs) with other financial institutions in matters relating to recovery, it is proposed that NBFCs registered with RBI and having asset size of ₹500 crore and above will be considered for notifications as* Financial Institution *in terms of the SARFAESI Act, 2002'.*

# *Chapter 5:*
# Estimation of Costs

## 1. Background

The previous chapter identified the sub-optimal nature of provisions and other issues remained uncovered under the SARFAESI Act and DRT Act. Further, the chapter corroborated the deficient nature of provisions and absence of provisions under the aforesaid legislations, through literature review, review of existing research and experts reports, primary data collection, and stakeholder consultations undertaken under this project.

This chapter intends to undertake a theoretical estimation of additional costs on multiple stakeholders owing to existence of such sub-optimal provisions and absence of optimal provisions, for ascertaining and highlighting their impact on various stakeholders.

## 2. Identification of Costs

Regulations/legislations usually have widespread impacts, which affect the multiple stakeholder groups in different ways. A sub-optimal regulation/legislation could lead to higher costs of compliance, increased complexity and uncertainty associated with regulatory obligations, and most importantly, limits the likelihood of achievement of intended objectives.

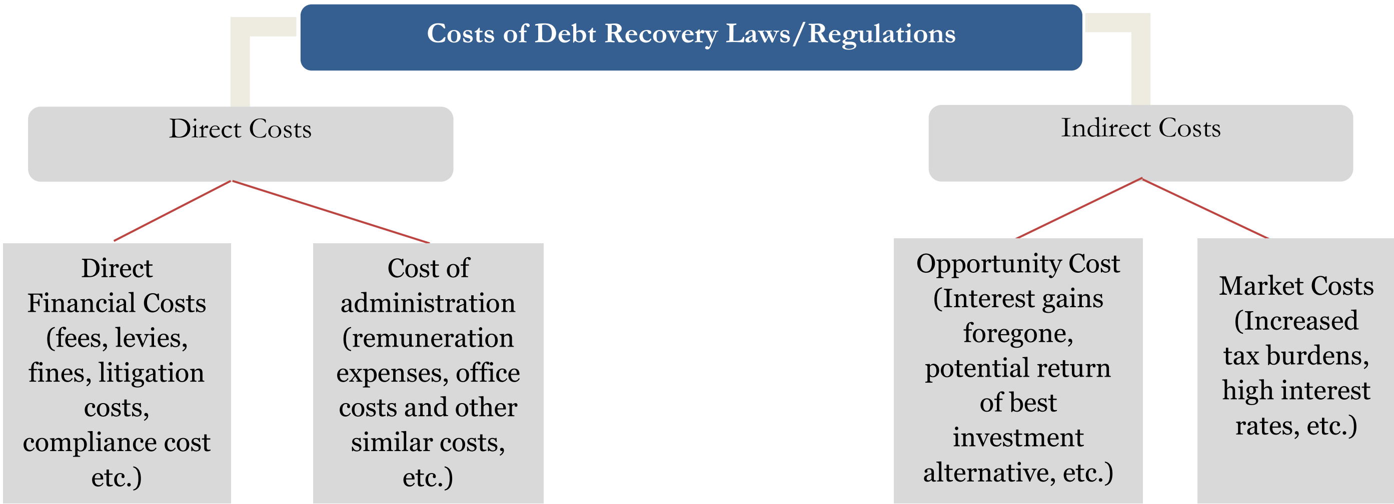
The costs of legislations can be broadly classified into two broad categories – Direct Costs and Indirect Costs. **Direct costs** involve direct financial costs, costs of compliance with the regulation/legislation, administrative costs, etc. These include regulatory charges, such as fees, levies and fines paid directly to the enforcing agency and/or government. Further, compliance cost includes 'hassle cost', reflecting time and resources spent in complying with relevant laws/regulations.[178] Thus with respect to debt recovery, the cost of compliance is what banks and financial institutions, and borrowers incur in meeting legal and regulatory requirements stipulated under the SARFAESI Act and DRT Act. Administrative cost is the cost incurred by the government in implementation of law/regulation, including its effective enforcement.

**Indirect costs** include the costs, which are additional costs and are not accounted for by the direct costs. These include costs of delays (calculated as revenue loss/opportunity costs), impact on market structure, facilitation payments, etc.

[178] Third Report of the Tax Administration Reforms Commission, Ministry of Finance, available at: *http://finmin.nic.in/the_ministry/dept_revenue/tarc_report.asp*

**Figure 5.1** illustrates different types of costs that sub-optimal provisions/absence of provisions can impose on banks and financial institutions, government, regulators and public at large.

**Figure 5.1: Costs of Debt Recovery Laws/Regulations**




The following sections are divided into two broad heads – the DRT Act and SARFAESI Act. Each section provides a theoretical estimation of superfluous costs imposed on various stakeholders, owing to sub-optimal provisions/absence of optimal provisions in the DRT Act and SARFAESI Act.

### *2.1. DRT Act*

As discussed in the previous chapter, cases in RTs are subject to long delays, and consequently result in incremental costs on stakeholders' involved as amounts locked up in legal proceedings results in severe under-utilisation of resources. In other words, delay in decision making and consequent recovery of bank dues increases cost for different categories of stakeholders, viz., banks and financial institutions, government/regulators and society. The costs are computed on the basis of delay in decision making at RTs and other issues impending performance of RTs.

#### *2.1.1. Opportunity Cost*

The concept of opportunity cost emphasises the problem of choice. Opportunity costs are technically referred to as implicit cost of capital raised and invested. It may be defined as the rate of return associated with the best investment opportunity that would be foregone. In other words, opportunity cost is the potential additional return on the opportunity foregone by not putting funds elsewhere because they have been invested in other investment avenues. With respect to recovery of bank dues, opportunity cost includes the interest gains foregone on amount stuck in NPA cases locked up in legal proceedings for substantially longer periods.

In this regard, a study of randomly selected cases pending before/disposed by four DRTs (Chandigarh DRT, Jabalpur DRT, Jaipur DRT and Lucknow DRT) was carried out under the project (as mentioned in the previous chapter). It was observed that the recommendatory timeframe of 180 days (approximately six months) to dispose of the application (as provided under the DRT Act), is hardly complied with. Around 75 percent of the cases were dragged on for more than a period of one year. As a result, approximately six months of interest gains are foregone on these cases.

An illustrative list of cases pending before/disposed by above mentioned DRTs, and the actual time taken along with approximate delay in disposing the cases is summarised in **Table 5.1**. For a diagrammatic representation of **Figure 5.1**, see **Figure 4.3** in the earlier chapter.

**Table 5.1: List of Cases with Actual Time Taken (along with approximate delay)**

| Case Name | DRT | Date of filing | Date of disposal | Actual time taken | Approximate delay |
|---|---|---|---|---|---|
| Kamesh Bhargava Hospital vs. DRAT & Ors. | Chandigarh | June 2007 | July 2011 | >4 years | 43 months |
| M/s A Private Limited (Borrower) vs. Public Sector Bank* | Chandigarh | March 2012 | Yet to be disposed of | 3 years | 30 months |
| Mr. B (Borrower) vs. Public Sector Bank* | Jabalpur | July 2010 | December 2012 | 2 years & 5 months | 23 months |
| M/s C Private Limited (Borrower) vs. Public Sector Bank* | Jaipur | March 2008 | December 2009 | 1 year & 8 months | 14 months |
| KSL & Industries Limited vs. M/s Arihant Threads Limited and Ors. | Chandigarh | December 2001 | July 2003 | 1 year & 7 months | 13 months |
| M/s D & Sons (Borrower) vs. Public Sector Bank* | Lucknow | February 2010 | March 2011 | 1 year & 1 month | 7 months |
| M/s E Private Limited (Borrower) vs. Public Sector Bank* | Jaipur | July 2013 | May 2014 | 10 months | 4 months |

** Information in relation to these cases has been provided on the condition of anonymity. Hence, names remain undisclosed.*

Accordingly, delay in disposing of the matter (average delay of 19 months) was noticed in all cases, and not even a single case got disposed of within the recommendatory time frame of 180 days. This has the potential to foist additional costs in the form of interest gains foregone (opportunity cost) on banks and financial institutions. Table 5.2 depicts additional cost on account of amount stuck in cases pending for extended time beyond recommendatory time period provided under the DRT Act.

**Table 5.2: Calculation of Opportunity Costs**

| Case Name | Amount (₹ in crore) | Present Value[179] (₹ in crore) | Opportunity Cost[180] (₹ in crore) |
|---|---|---|---|
| Kamesh Bhargava Hospital vs. DRAT & Ors. | 1.78 | 2.34 | 0.56 |
| M/s A Private Limited (Borrower) vs. Public Sector Bank | 4.96 | 6.02 | 1.06 |
| Mr. B (Borrower) vs. Public Sector Bank | 5.17 | 6.00 | 0.83 |
| M/s C Private Limited (Borrower) vs. Public Sector Bank | 4.54 | 4.97 | 0.43 |
| KSL & Industries Limited vs. M/s Arihant Threads Limited and Ors. | 25.27 | 27.47 | 2.20 |
| M/s D & Sons (Borrower) vs. Public Sector Bank | 6.47 | 6.77 | 0.30 |
| M/s E Private Limited (Borrower) vs. Public Sector Bank | 52.41 | 53.81 | 1.40 |
| **Total** | **100.60** | **107.38** | **6.78** |

Table 5.2 reveals that the total additional cost of ₹6.78 crore (in the form of interest loss) is put on secured creditors, owing to delayed recovery of outstanding debts, by around 19 months. Simply stated, the average time period for recovery of every ₹100 crore due is around 25 months (statutory period of 6 months and average delay of 19 months), resulting in opportunity cost of around ₹6 crore[181] This results in distrust in the banking sector, which has an adverse impact on economy as a whole.

While the average time taken to dispose of matters is around two years, often, cases are dragged beyond two years, up to four years. This has been validated by stakeholders as well.

Experts have indicated that only about one-fourth of the cases pending at the beginning of the year get disposed of during a particular year – suggesting a four year wait even if the DRTs focus only on old cases.[182] Accordingly, approximately 75 percent of cases remain pending for two years. Similarly, 50 percent and 25 percent of cases remain pending for 3 years and 4 years respectively, which consequently have cost attached to it (assuming that around 25 percent of the cases get disposed of within the recommendatory period of 180 days).

179 Present value is calculated considering an annual inflation/risk free rate of interest of around 8 percent. Present value is calculated as on the date of disposal of matter.
180 Interest lost.
181 The above calculation is done on the basis of given sample size of cases. Different sample size may lead to variable results.
182 Supra note 45.

As on March 31, 2014, a total of 66,971 matters/cases involving ₹141,500 crore are pending at 33 DRTs across the country.[183] Considering a four year wait to dispose all the pending cases, the amount which banks and financial institutions can hope to recover is a pittance. Consequently, delay in obtaining decisions in relation to outstanding debts leads to incremental opportunity cost to banks and financial institutions.

Assuming that of the amount due at the end of fiscal 2014, 25 percent will be recovered every subsequent fiscal, Table 5.3 depicts the additional costs on account of cases pending beyond recommendatory time period provided under the DRT Act.

**Table 5.3: Calculation of Sector wide Opportunity Costs**

| S. No. | Proportionate Share recovered (in %) | Amount recovered (₹ in crore) (A) | Period of additional pendency[184] | Present Value[185] (₹ in crore) (B) | Opportunity Cost ₹ in crore) (B-A) |
|---|---|---|---|---|---|
| 1. | 25 | 35,375 | 36 months | 44,562 | 9,187 |
| 2. | 50 | 70,750 | 24 months | 82,523 | 11,773 |
| 3. | 75 | 106,125 | 12 months | 114,615 | 8,490 |
| | **Total** | | | | **29,450** |
| | **Estimated loss** | | | | **25,000** |

Table 5.3 reflects that the total additional cost to be borne by banks and financial institutions is as high as ₹25,000 crore. In addition, when recovery actually takes place, the enterprise has usually been stripped clean of value.[186]

DRATs are also subject to similar problem, as cases before DRATs are disposed of with protracted delays. A detailed analysis of 22 randomly selected cases pending before/ disposed by DRAT Chennai under the project reveals that around 73 percent were pending for more than one year, and recommendatory time period under the DRT Act is complied with in rare cases. [187]

A list of cases pending before/disposed by DRAT Chennai, and the actual time taken along with approximate delay is disposing the cases is summarised in Table 5.4. For a diagrammatic representation, see Figure 4.4 in the previous chapter.

**Table 5.4: List of Cases with Actual Time Taken (along with approximate delay)**

[183] Supra note 70.
[184] Assuming normal pendency as one year.
[185] Present value is calculated considering an annual inflation of around 8 percent.
[186] Supra note 45.
[187] Analysis of cases pending before/disposed by DRAT Chennai is done owing to availability of data in public domain. Further, we have noticed that majority of DRTs/DRATs either do not have their websites or they do not publish relevant data on their web sites.

| Name | Amount (₹ in Lakh) | Period involved | Actual time taken | Statutory time period | Approximate delay |
|---|---|---|---|---|---|
| Moily Joseph v. PNB | 56.50 | July 2010- December 2011 | 1 year and 5 months | 6 months | 9 months |
| S Geetha v. BoI | 4.00 | July 2010- July 2013 | 3 years | 6 months | 30 months |
| G Umashankar & anr v. ING Vysya Bank Ltd. | 11.21 | July 2010 - March 2013 | 2 years and 8 months | 6 months | 26 months |
| Praneeth Tobacco Company v. Central Bank | 13.00 | July 2010 - March 2012 | 1 year and 8 months | 6 months | 14 months |
| Precision Fastening v. State Bank of Mysore | 72.00 | September 2010- May 2014 | 3 years and 8 months | 6 months | 38 months |
| Shakeel Ahmed I Kalghatgi v. A.O., SBI | 135.00 | October 2010 - March 2012 | 1 year and 5 months | 6 months | 9 months |
| Srinivasan v. The Indian Bank | 52.00 | October 2010 - March 2012 | 1 year and 5 months | 6 months | 9 months |
| M/s. Rajendra Rice mill v. IOB | 130.00 | November 2010 - December 2014 | 4 years and 1 month | 6 months | 43 months |
| M/s Arunachaleswarar Mills & ors v. The A.O., Indian Bank | 356.00 | November 2010 - March 2013 | 2 years and 4 months | 6 months | 22 months |
| M/s Janata Seva And Cold Storage Pvt Ltd v. State Bank of India & anr | 390.00 | December 2010 - March 2013 | 2 years and 3 months | 6 months | 21 months |
| K K Palanivelan v. The State Bank of India & ors | 1266.00 | December 2010 - July 2011 | 7 months | 6 months | 1 month |
| S Purushothaman v. City Union Bank Ltd. | 97.00 | January 2011 - January 2012 | 1 year | 6 months | 6 months |
| S Ravi & anr v. AO, ICICI Bank Ltd. | 20.00 | January 2011 - March 2012 | 1 year and 2 months | 6 months | 8 months |
| P Karnan v. A.O., Vijaya Bank | 13.00 | February 2011 - February 2015 | 4 years | 6 months | 42 months |
| H S Gangadhar v. The Authorised Officer, Indian Bank &ors | 207.00 | March 2011 - February 2012 | 11 months | 6 months | 5 months |
| N Santhanam v. A.O., Punjab & Sind Bank & anr | 86.00 | May 2011 - April 2013 | 1 year and 11 months | 6 months | 17 months |

| Name | Amount (₹ in Lakh) | Period involved | Actual time taken | Statutory time period | Approximate delay |
|---|---|---|---|---|---|
| V Gopalakrishnan V/S Indian Bank | 8000.00 | April 2011 - August 2013 | 2 years and 4 months | 6 months | 22 months |
| St. Marys Hotel (P) ltd V/S A. O., The Kottayam Dist Co-operative Bank Ltd. | 341.00 | May 2011 - June 2014 | 3 years and 1 month | 6 months | 31 months |
| Ravindra G Kolle & anr V/S SBI | 912.00 | August 2010 -October 2010 | 3 months | 6 months | No delay |
| M/s Landmark Infrastructures V/S IOB | 533.00 | October 2010 - March 2011 | 5 months | 6 months | No delay |
| Manrish Textile Corporation & ors V/S BOB & anr | 1100.00 | January 2011-April 2011 | 4 months | 6 months | No delay |
| B S Suganya V/S IOB | 135.00 | March 2011- June 2011 | 3 months | 6 months | No delay |

Accordingly, delay (average delay of 16 months) was noticed in more than 80 percent of the cases studied, which consequently has costs attached to it.

**Table 5.5** depicts additional cost on account of amount stuck in cases pending for extended time period beyond recommendatory time period provided under the DRT Act.

**Table 5.5: Calculation of Opportunity Cost**

| Name | Amount (₹ in Lakh) | Approximate delay | Present Value[188] (₹ in Lakh) | Opportunity Cost (₹ in Lakh) |
|---|---|---|---|---|
| Moily Joseph v. PNB | 56.50 | 9 months | 59.89 | 3.39 |
| S Geetha v. BoI | 4.00 | 30 months | 4.85 | 0.85 |
| G Umashankar & anr v. ING Vysya Bank ltd | 11.21 | 26 months | 13.25 | 2.04 |
| Praneeth Tobacco Company v. Central Bank | 13.00 | 14 months | 14.23 | 1.23 |
| Precision Fastening v. State Bank of Mysore | 72.00 | 38 months | 91.90 | 19.90 |
| Shakeel Ahmed I Kalghatgi v. A.O., SBI | 135.00 | 9 months | 143.10 | 8.10 |
| Srinivasan v. The Indian Bank | 52.00 | 9 months | 55.12 | 3.12 |

[188] Present value is calculated considering an annual inflation of around 8 percent.

| Name | Amount (₹ in Lakh) | Approximate delay | Present Value[188] (₹ in Lakh) | Opportunity Cost (₹ in Lakh) |
|---|---|---|---|---|
| M/s. Rajendra Rice mill v. IOB | 130.00 | 43 months | 171.40 | 41.40 |
| M/s. Arunachaleswarar Mills & ors v. The A.O., Indian Bank | 356.00 | 22 months | 410.11 | 54.11 |
| M/s. Janata Seva And Cold Storage Pvt Ltd v. State Bank of India & anr | 390.00 | 21 months | 446.47 | 56.47 |
| K K Palanivelan v. The State Bank of India & ors | 1266.00 | 1 month | 1274.44 | 8.44 |
| S Purushothaman v. City Union Bank ltd | 97.00 | 6 months | 100.88 | 3.88 |
| S Ravi & anr v. AO, ICICI Bank Ltd. | 20.00 | 8 months | 21.07 | 1.07 |
| P Karnan v. A.O., Vijaya Bank | 13.00 | 42 months | 17.03 | 4.03 |
| H S Gangadhar v. The Authorised Officer, Indian Bank &ors | 207.00 | 5 months | 213.90 | 6.90 |
| N Santhanam v. A.O., Punjab & Sind Bank & anr | 86.00 | 17 months | 95.98 | 9.98 |
| V Gopalakrishnan V/S Indian Bank | 8000.00 | 22 months | 9216 | 1216 |
| St. Marys Hotel (P) ltd V/S A.O., The Kottayam Dist. Co-operative Bank Ltd. | 341.00 | 31 months | 416.30 | 75.30 |
| Ravindra G Kolle & anr V/S SBI | 912.00 | No delay | 912.00 | Nil |
| M/s Landmark Infrastructures V/S IOB | 533.00 | No delay | 533.00 | Nil |
| Manish Textile Corporation & ors V/S BOB & anr | 1100.00 | No delay | 1100.00 | Nil |
| B S Suganya V/S IOB | 135.00 | No delay | 135.00 | Nil |
| **Total** | **13929.71** | | **15445.92** | **1516.21** |

The above Table reflects the total additional cost of ₹1516.21 lakh (or ₹15.16 crore) is to be borne by banks and financial institutions on account of loss of interests gains, because of delay in disposing appeals by Chennai DRAT. Simply stated, the average time period for recovery of every ₹139 crore due is around 22 months (statutory period of 6 months and average delay of 16 months), resulting in opportunity cost of around ₹15 crore[189].

Currently, there are 5 DRATs functioning across the country.[190] As on December 31, 2014, total number of cases collectively pending before 5 DRATs is 1,010.[191] This means that around 200 cases are pending per DRAT on an average. Given that DRATs are overburdened with colossal number of cases and consequently, it might be beyond the capacity of merely five persons (one Chairperson per DRAT), to expeditiously deal with such huge pendency. As a result, banks and financial institutions have to bear the cost, owing to such delay.[192]

*2.1.2. Market Costs*

Market costs are the costs on other stakeholders in the market, such non-defaulting borrowers, depositors, and taxpayers.

Experts have noted that when the large promoter defaults and secured creditors fails to recover the outstanding bank dues, the hard working savers and honest taxpayers of the country pay for such default.[193] In other words, while the unscrupulous borrowers enjoy a privileged existence, risking other people's money, the latter have to suffer in form of higher interest rates, increased tax burden, and other social costs.

It has also been noted that the promoter who misuses the system ensures that banks then charge a premium for bank loans. The average interest rate on loans to the power sector is 13.7 percent even when the policy rate is around 8 percent. The excess of interest rate on power sector loans over the policy rate (commonly known as credit risk premium) to the extent of 5.7 percent, is largely compensation banks demand for the risk of default and non-payment. Even comparing the interest rate on power sector loan with average rate available on home loan of 10.7 percent, it is obvious that genuine power sector firms are paying much more than the average household (precisely by 300 basis points) because bank worries about whether they will recover loans.[194]

Further, experts have noted the social cost of the amount of loans (i.e.,₹161,018 crore, equivalent to 1.27 percent of GDP) written off by commercial banks in past five years is as huge as it would have allowed 1.5mn of the poorest children to get a full university degree from top private universities of the country.[195]

Further, as seen in past, several governments have utilised taxpayers' funds to prevent bank failures, of which one of the reasons could be insufficient recovery of due amount. The

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[189] The above calculation is done on the basis of given sample size of cases. Different sample size may lead to variable results.

[190] List of DRATs, available at: *http://financialservices.gov.in/banking/ListOfDRATsAndDRTS.asp?pageid=1*, last visited on March 20, 2015.

[191] Report of the Department-related Parliamentary Standing Committee on Personnel, Public Grievances, Law and Justice, on the Tribunals, Appellate Tribunals and Other Authorities (Conditions of Service) Bill, 2014, presented to the Rajya Sabha on February 26, 2015.

[192] However, in the absence of amount involved in 1,010 cases pending before all five DRATs, calculation of opportunity cost is not possible.

[193] Supra note 45.

[194] Ibid.

[195] Ibid.

Indian government has also indicated that it will recapitalise PSBs, as and when required, and it believed that the government will not let large banks fail.[196] Such sub-optimal allocation of funds prevents utilisation of public money for public good. As a result, society as a whole has to bear the cost of mis-utilisation of public money by few impish borrowers.[197]

*2.1.3. Direct financial costs*

Direct financial costs include regulatory charges such as fees, levies and fines, which are paid directly to the enforcing agency and/or government. Further, litigation cost is also part of direct financial cost. Accordingly, application fee paid to initiate the RT proceedings, and litigation cost constitutes direct financial costs.

The minimum and maximum fee for filing of application at DRT (original application/ securitisation application) is ₹12,000 and ₹1.5 lakh respectively.[198] Similarly, maximum fee for filing appeal against the order of DRT is ₹30,000.[199] Interestingly, even after two decades of promulgation of the DRT Act, the fee structure under the Act has not changed. Further, when an appeal is filed in DRAT, then the borrower is required to deposit a portion of amount due with the DRAT (75 percent in case of matters under DRT Act and 50 percent in case of matters under Securitisation Act).

In addition, litigants have to bear advocates' fee and other litigation expenses as well. Stakeholder interactions revealed that total cost of litigation is approximately 4-5 percent of the due amount. With exponential increase in cases (involving large sum of outstanding debts) referred to DRTs, the opportunity cost of litigation is exceedingly high.

During the year 2013-14, a total of 28,258 cases (involving ₹55,300 crore) were referred to DRTs.[200] Consequently, the opportunity cost of litigation for the same period comes out to be around ₹2,000 crore.[201]

*2.1.4. Administrative cost*

Administrative cost is the cost incurred by the government in administering law, including its effective enforcement. In other words, the expenses associated with the management and direction of a programme, policy or law is termed as administrative cost. It typically includes executive compensation, office costs and other expenses not directly associated with the execution of the activity.

The Union Budget for 2015-16 allocated ₹102.28 crore for RTs for the year 2015-16, which is around 35.38 percent higher than the revised budget estimate of ₹75.55 crore for the year

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196 *"Recapitalisation of PSU Banks on high priority: Jaitley"*, available at: http://www.thehindu.com/business/recapitalisation-of-psu-banks-on-high-priority-jaitley/article6228316.ece, last visited on March 28, 2015

197 See, *Government announces capital infusion of ₹6990 crore in Public Sector Banks,* Live Mint, February 07, 2015, available at: http://www.livemint.com/Money/R9vmXEfkGm7w5yih5U0SJK/Govt-to-infuse-Rs6990-crore-in-9-PSBs-SBI-leads-the-pack.html, last visited on March 20, 2015. Also see, *Responding to the distress in Indian banking,* Economic Times, June 30, 2014, available at: http://www.mayin.org/ajayshah/MEDIA/2014/amco.html, last visited on March 20, 2015.

198 The DRT (Procedure) Rules, 1993

199 The DRAT (Procedure) Rules, 1994

200 Statistical Tables Relating to Banks in India, *Table 19: NPAs of scheduled commercial banks recovered through various channels*, December 2014

201 Assuming an average 4 percent litigation cost, based on the stakeholders' interaction.

2014-15.[202] Similar jump in budget allocations to RTs can be noticed in the immediate previous year, where the revised budget estimate for the year 2014-15 is around 44.58 percent higher than actual budget allocation of ₹52.25 crore for the year 2013-14.[203] Consequently, considerable administrative cost is incurred by the government for effective management and administration of RTs.

### *2.2. SARFAESI Act*

As discussed in the previous chapter, the SARFAESI Act was enacted with the objective to make the debt recovery swifter. The intent of law makers was to enable banks and financial institutions enforce their security interest, without going through the stringent court procedure so that debts could be recovered speedily. But the SARFAESI Act has not been successful in achievement of its objectives. Sub-optimal provisions/absence of optimal provisions under SARFAESI Act have resulted in inordinate delays in debt recovery, leading to imposition of significant costs on stakeholders.

*2.2.1. Opportunity Cost*

The recovery rate of matters pending under SARFAESI Act in the fiscal 2011-12 was 28.62 percent, which subsequently reduced to 27.16 percent and 25.80 percent in 2012-13 and 2013-14, respectively.[204] Therefore, the average recovery ratio comes out to be around 27 percent, which means that even assuming that the entire amount would be recovered in due course, still it will take at least 3.5 years to recover that amount.[205]

As on March 31, 2014, total amount remain unrecovered under the SARFAESI mode was ₹70,200 crore.[206] Considering that three and half years would be required to recover the total amount, Table 5.6 below depicts the additional costs on account of inordinate delay in recovery of due debt under the SARFAESI mode.

**Table 5.6: Calculation of Additional Costs**

| S. No. | Proportionate Share recovered (in %) | Amount recovered (₹ in crore) (A) | Period of additional pendency[207] | Present Value[208] (₹ in crore) (B) | Additional Cost (₹ in crore) (B-A) |
|---|---|---|---|---|---|
| 1. | 19.00 | 13,338 | 36 months | 16,802 | 3,464 |
| 2. | 46.00 | 32,292 | 24 months | 37,665 | 5,373 |
| 3. | 73.00 | 51,246 | 12 months | 55,345 | 4,100 |
| | **Total** | | | | **12,937** |
| | **Estimated loss** | | | | **10,000** |

[202] Union Budget 2015-16 (Demand No. 35, Department of Financial Services, Ministry of Finance), available at: *http://indiabudget.nic.in/ub2015-16/eb/allsbe.pdf*, last visited on March 25, 2015.
[203] Ibid.
[204] Report on Trends and Progress of Banking in India, Reserve Bank of India.
[205] Stakeholders' consultation revealed that it should ideally take not more than six months to recover amount outstanding dues under the SARFAESI mode.
[206] Statistical Tables Relating to Banks in India, *Table 19: NPAs of scheduled commercial banks recovered through various channels*, December 2014.
[207] Assuming recovery of around 27 percent amount in first year.
[208] Present value is calculated considering an annual inflation of around 8 percent.

Table 5.6 reflects that the total additional cost to be borne by banks and financial institutions is as high as ₹10,000 crore.

The above opportunity cost would further be increased by the costs put on secured creditors, owing to delay in decision making at RTs since the SARFAESI matters are also referred to RTs.[209] Table 4.5 in the previous chapter lists out select cases, which remained pending for prolonged period on account of delay in settlement and non-appearance of parties. Similarly, most DRTs and DRATs across the country are also subject to similar delays in disposing of securitisation applications. This has been revealed by analysis undertaken under the project, and further corroborated by stakeholders consulted.

In addition, a review of select cases under the project suggests that even when borrowers fail to discharge their liability within the stipulated time period; considerable time passes before banks or financial institutions are in a position to take relevant actions under the provisions of the SARFAESI Act. This inflicts costs on banks and financial institutions in the form of interest gains foregone.

Table 5.7 depicts an illustrative list of cases where action under Section 13(4) of the SARFAESI Act was taken after substantial period of time, resulting in additional costs on secured creditors.

**Table 5.7: List of Cases with Delayed Action Taken u/s 13(4)**
**(along with additional costs owing to such delay)**

| Case Name | Date of 13(2) notice | Date of taking action u/s 13(4) | Delay in taking action[210] | Amount involved (₹ in Lakh) | Present Value[211] (₹ in Lakh) | Additional costs (₹ in Lakh) |
|---|---|---|---|---|---|---|
| M/s A Private Limited vs. Public Sector Bank* | November 07, 2013 | April 29, 2014 | 83 days | 77.54 | 78.95 | 1.41 |
| Shri Siddeshwara Co-operative Bank Ltd. vs. Ikbal and ors. (SC) | June 30, 2005 | December 18, 2005 | 81 days | 10.43 | 10.61 | 0.18 |
| M/s B & Sons (Borrower) vs. Public Sector Bank* | September 10, 2009 | February 3, 2010 | 56 days | 600.47 | 607.84 | 7.37 |
| Somnath Manocha vs. Punjab & Sindh Bank & ors. (Delhi HC) | November 20, 2004 | April 13, 2005 | 53 days | 384.60 | 389.07 | 4.47 |
| Jayant Agencies vs. Canara Bank and anr. (Jharkhand HC) | January 13, 2010 | May 31, 2010 | 48 days | 56.92 | 57.52 | 0.60 |
| M/s C Private Limited | October | February | 43 days | 72.45 | 73.13 | 0.68 |

[209] Section 17 and 18 of the SARFAESI Act, 2002.
[210] Delay is calculated after the expiry of 90 days (60 days as specified u/s 13(2) of the Act + a reasonable period of 30 days to take action u/s 13(4)).
[211] Present value is calculated considering an annual inflation of around 8 percent.

| Case Name | Date of 13(2) notice | Date of taking action u/s 13(4) | Delay in taking action[210] | Amount involved (₹ in Lakh) | Present Value[211] (₹ in Lakh) | Additional costs (₹ in Lakh) |
|---|---|---|---|---|---|---|
| vs. Public Sector Bank* | 14, 2010 | 25, 2011 | | | | |
| Mr. D (Borrower) vs. Public Sector Bank* | June 12, 2007 | October 18, 2007 | 37 days | 85.00 | 85.69 | 0.69 |
| Dauli Kumari vs. the State of Bihar (Patna HC) | August 18, 2006 | December 15, 2006 | 28 days | 11.52 | 11.59 | 0.07 |
| **Total** | | | | **1298.93** | **1314.40** | **15.47** |

* *Information in relation to these cases has been provided on the condition of anonymity. Hence, names remain undisclosed.*

Table 5.7 reveals that the total additional cost of ₹15.47 lakh, equivalent to 1.19 percent (in the form of interest loss) is put on secured creditors, owing to delay in taking action, by approximately 54 days.

*2.2.2. Market costs*

When a borrower defaults and as a result, bank suffers loss, someone has to pay for it. These are the honest taxpayers of the country, who actually pays for the default of the defaulting borrowers. Therefore, market costs are the costs on imposed taxpayers and citizens of the country.

To make securitisation process efficient, government has proposed setting up of specialised securitisation and asset reconstruction companies. Setting up of such specialised agencies by the government, with public money and selling bad loans outright at market price to them, has cost attached to it. Desk research reveals that the government is looking at the option of setting up of National Asset Management Company (NAMCO) with public money for transferring bad assets to it. NAMCO will have ₹20,000 crore of equity capital and it will issue ₹80,000 crore of government-guaranteed bonds.[212] Therefore, setting up of a specialised entity like NAMCO has an opportunity cost as ₹1,00,000 crore of public money could retire ₹1,00,000 crore of public debt or build 10,000 crore of six-lane expressways.[213]

*2.2.3. Direct financial costs*

As mentioned above, direct financial costs comprise regulatory charges, such as fees, levies and fines, which are paid directly to the enforcing agency and/or government.

Every securitisation application[214]/ appeal[215] filed with RTs is accompanied by a fee, which could be as high as ₹100,000.[216]

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[212] *"Asset reconstruction companies should rid banks of bad debt",* available at: http://articles.economictimes.indiatimes.com/2014-06-30/news/50974320_1_equity-capital-bad-assets-bad-loans, last visited on March 28, 2015.

[213] Ibid.

[214] Section 17 of the SARFAESI Act, 2002.

[215] Section 18 of the SARFAESI Act, 2002.

[216] The Security Interest (Enforcement) Rules, 2002.

In addition, banks and financial institutions have to bear litigation fee, payment to enforcement agencies, publication cost, and other litigation expenses as well. Stakeholder interactions revealed that total cost comes out to be approximately 7-8 percent of the due amount.

While this chapter estimated the cost imposed by sub-optimal provisions/absence of optimal provisions under the DRT Act and SARFAESI Act, the following chapter discusses the statutory alternatives to select provisions in these legislations and estimates costs and benefits thereof.

# *Chapter 6:* Alternatives and their Impact

## 1. Background

The previous chapters have discussed the baseline scenario with respect to the DRT Act and the Securitisation Act, unreasonable costs imposed on stakeholders on account of sub-optimal provisions of these Act, or the absence of adequate provisions.

This chapter attempts to provide legislative alternatives to select provisions in these legislations, with the objective of reduction in costs, and consequent improvement in benefits. The chapter is divided in two broad sections discussing legislative alternatives to select provisions of DRT Act and Securitisation Act, and their consequent impact.

## 2. DRT Act

### *2.1. Threshold for filing applications at RTs*

*Alternative 1: Increase in threshold limit and placing the same in schedule, subject to periodic review*

In order to ensure that number of matters filed at DRTs remain manageable, and prevent filing of insignificant matters, it is suggested that the eligibility criteria for filing application at DRT be revised.[217] The DRT Act should not provide any financial eligibility criteria, which must be put in its Schedule. As the financial threshold has not be revised since enactment of the DRT Act, a review of the amount must be undertaken and the same should be revised on the basis of rate of inflation/ inflation index since enactment of statute. Further, a specific Section could be added in the DRT Act that amount in the Schedule be reviewed every three years on the basis of inflation index, and revision of amount will be possible through executive order, notified to the Parliament. This would also require an amendment in Section 1(4) of the DRT Act. Similarly, it is suggested that a periodic review of application fees be carried out, and same should be suitably amended.

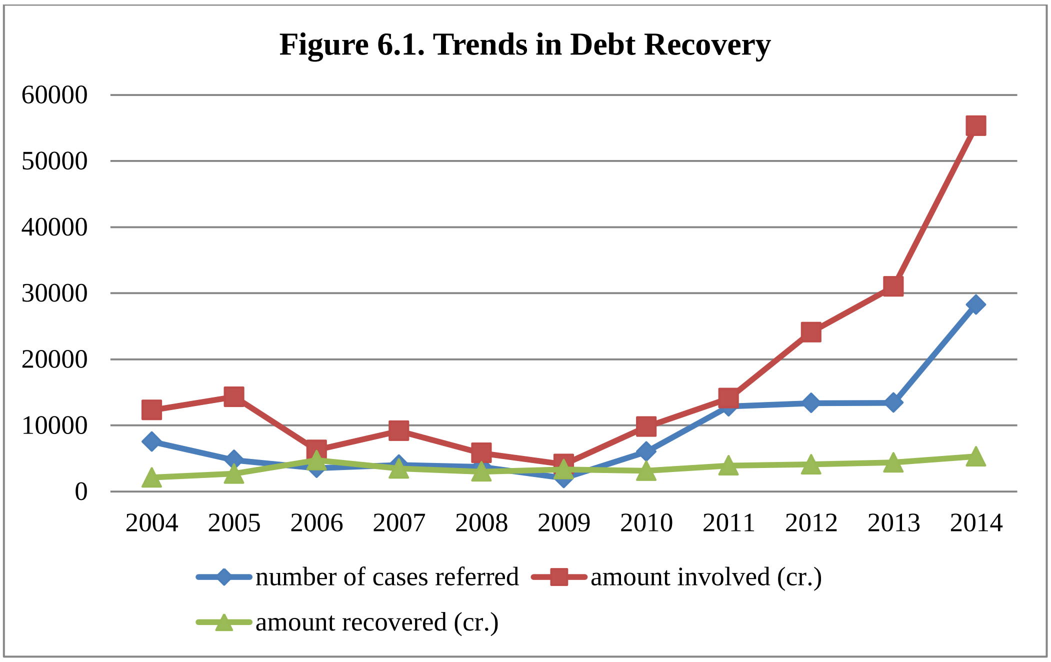
[217] "*A debt recovery suit against a borrower can be filed in a DRT only if the claim is larger than Rupees 1 million (approximately $20,000). The rationale for this stipulation appears to have been as follows. First, by restricting the size of the claim that would be eligible for DRTs, this avoids overcrowding the DRTs. Second, given the large fixed cost of litigation, the larger non-performing loans are also most attractive to recover. The DRTs were envisioned as helping banks recover bad loans from the larger corporate borrowers. The exact threshold appears to have been chosen because it was a convenient round number. There is no evidence to suggest that there were any economic reasons for this choice*", Visaria, *Legal Reform and Loan Repayment: The Microeconomic Impact of Debt Recovery Tribunals in India*, Boston University, April 2006, available at: http://www.bu.edu/econ/files/2012/11/dp157-Visaria.pdf, last accessed on March 27, 2015.

*Costs of alternative 1*
As a result of alternative 1, assuming an average annual risk free interest rate of around 5 percent[218], the threshold limit needs to be revised to around ₹25 lakh, from current ₹10 lakh. Similarly, the minimum application fee needs to be revised to around ₹30,000. As a result, potential applicants of threshold below ₹25 lakh, or not in a position to pay minimum application fee of ₹30,000, will have to approach civil courts for recovery of debts. Estimates suggest that time taken for hearing of matters at civil courts is significantly longer, when compared with the RTs.[219] This will increase the opportunity cost for such applicants.

*Cost of alternative 1: Increase in opportunity cost of potential applicants who will not be in a position to pay the increased application fee of ₹30,000 or with matters valued below ₹25 lakh.*

*Benefits of alternative 1*
While evidence does not suggest a direct causal relationship between reduction in number of cases and increase in disposal rate (see Figure 6.1), an increase in threshold limit is expected to reduce the number of matters filed at RTs, thereby lighten the burden on DRTs and have a positive impact on disposal rate. An improvement in disposal rate is also expected to reduce the pendency and consequently save the opportunity cost for existing litigants.

*Benefit of alternative 1: Reduction in the rate of increase of pendency at RTs*




*Source: Statistical Tables Relating to Banks in India, Table 19: NPAs of scheduled commercial banks recovered through various channels, December 2014*

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218 [www.indiastat.com](http://www.indiastat.com), inflation related indices.
219 Visaria, *Legal Reform and Loan Repayment: The Microeconomic Impact of Debt Recovery Tribunals in India*, Boston University, April 2006, available at: *http://www.bu.edu/econ/files/2012/11/dp157-Visaria.pdf*, last accessed on March 27, 2015, found that Bombay High Court was taking around twice the time as Mumbai DRTs, for issuance of summons, first hearing, taking on record applicant's and defendant's evidence, and start of arguments.

As is evident from Figure 6.1, the amount recovered/ disposal rate has not undergone significant changes with change in number of cases referred at RTs and consequent amount involved.

*Alternative 2: Power to central government to determine the threshold limit in rules*
It is suggested that the threshold limits for application of DRT Act must not be stated in the statute. The central government must have the power to determine the limit through Rules, in consultation with the RTs, on the basis of capability and efficiency of RTs, measured on an on-going basis. Further, deciding the application fees must also be prerogative of RTs, which should keep in mind that applicants are financial institutions who can afford to pay for speedy recovery of loans.[220]

However, central government must be required to provide reasons and undertake a regulatory impact assessment, estimate and highlight additional cost and benefits of the revised threshold limits, before adopting the same.

*Costs of alternative 2*
There might not be any immediate costs of alternative 2, other than the cost of undertaking a regulatory impact assessment should the government wish to revise the threshold limits. The costs will be accrued once the threshold limits are changed. Owing to absence of immediate change on account of alternative 2, the baseline scenario is expected to continue.

*Costs of alternative 2: Cost to undertake regulatory impact assessment*

*Benefits of alternative 2*
There might not be any immediate benefits of alternative 2, other than greater flexibility with the central government to revise the threshold limits to approach the RTs. The benefits will accrue once the threshold limits are changed. Owing to absence of immediate change on account of alternative 2, the baseline scenario is expected to continue.

*Benefits of alternative 2: Increased flexibility with central government*

### *2.2. Number of RTs*

*Alternative 1: Increase in the number of RTs*
As discussed earlier, the average number of cases currently pending per RT is around 2.5 times the ideal pendency per DRT (as recommended by Deshpande Committee). Consequently, there is a need to increase the number of DRTs.[221]

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[220] Similar suggestions have been made by FSLRC Working Group on Banking (2013). The working group observed, "*In our view, the threshold limits for application of RDDBFI (1993) must not be stated in the act. The Central Government must have the power to determine the limit through rules. In addition, the capability and efficiency of DRTs must be measured on an ongoing basis and limitations must be addressed efficiently. The threshold limit after which cases may be filed before the DRT may be decreased only if the efficiency and capability permit,*" and "*There is merit in empowering the DRTs to determine the filing fees by keeping in mind the overall costs for their effective functioning. The applicants who file petitions before DRTs are financial institutions which can afford to pay for speedy recovery of loans made by them. Currently, only the Central Government has the power to make regulations prescribing the fees. Since the recommendation of this WG is to grant more independence to DRTs for allocating resources, deciding the quantum of fees should be their prerogative and is a necessary outcome of such independence*".

[221] RBI Discussion Paper on Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Economy, notes, "*Additional DRT benches at centres with large backlogs may be created. A separate bench for*

Budget 15-16 allocates ₹102.28 crore for debt recovery tribunals.[222] Assuming that the six additional DRTs as proposed by government in budget 14-15 will be functional during fiscal 16, the average allocation per DRT comes to around ₹2.62 crore (exclusive of DRATs, and additional infrastructure cost for setting up of DRT).

The cost and benefits of increase in number of DRTs is expected to be positively correlated to the number of additional DRTs proposed to be established. This will depend on the number of cases expected to be pending at DRTs.

- *Scenario 1: High pendency*

Assuming an increase in pendency by around 50 percent, that the total number of matters pending at DRT on March 31, 2015 are expected to be close to 90,000[223], making average pendency around 2300 cases per PO.[224] In order to reach ideal pendency of 800 cases per DRT, the total number of DRTs required would be around 112, i.e. 73 additional DRTs.

*Cost of scenario 1*
The cost of establishing and operationalising additional 73 DRTs is expected to be close to ₹192 crore (in addition to infrastructure cost)  In addition, significant efforts for identification of skilled candidates capable of manning DRTs, strategic planning of location and jurisdiction of DRTs etc. would be required.

*Direct cost of scenario 1: ₹192 crore, additional infrastructure cost*
*Indirect cost of scenario 1: significant efforts and costs in identification of skilled candidates, planning of location and jurisdiction of DRTs.*

- *Scenario 2: Low pendency*

Average annual pendency during past few years has been around 50,000 cases.[225] Assuming no change in average pendency during fiscal 2015, the total number of DRTs required to achieve ideal pendency would be around 63, i.e. 24 more than the existing number.

The cost of establishing and operationalising additional 24 DRTs is expected to be close to ₹63 crore (in addition to infrastructure cost) In addition, reasonable efforts for identification of skilled candidates capable of manning DRTs, strategic planning of location and jurisdiction of DRTs etc. would be required.

*Direct cost of scenario 2: ₹63 crore, additional infrastructure cost*

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*speedy disposal of SARFAESI related cases may be established in DRTs. Further, adequate staffing of Recovery Officers may have to be ensured by the Government*". Similar recommendations have been made with respect to civil and constitutional courts. In the All India Judges' Association Case [(2002) 4 SCC 247], the Supreme Court directed the Central and State governments to consider increasing the number of judges five-fold in a phased manner over a five year period in order to achieve the judge to population ratio as 50 per million.

[222]While the government used to provide break-up for capital and recurring expenditure in the budgets previously, the same was not available in latest budget of 15-16.

[223]The increase in the cases pending at DRT has been more than 50 percent from 2013 to 2014. As on March 31, 2013, total matters pending were 42,819, and the number increased to 66,971 within one year.

[224]It might be recalled that a DRT is supposed to be manned by a single PO (Section 3).

[225] The pendency in 2010, 2011, 2012, 2013, and 2014 have been around 37616, 54061, 63669, 42819, 66971 respectively, resulting an average of around 53027.

*Indirect cost of scenario 1: Reasonable efforts and costs in identification of skilled candidates, planning of location and jurisdiction of DRTs.*

In addition, an amendment in the DRT Act requiring government to ensure adequate RTs and POs/Chairpersons will be needed. The amendment should require the government to justify the location and jurisdiction of the proposed RTs and how the government proposal is expected to aid in meeting the objectives of the DRT Act.

*Benefits of alternative 1*
Alternative 1 is expected to reallocate matters across DRTs, and consequently reduce the pendency per RT. This is expected to improve the disposal rate and also the quality of orders passed by RTs. However, the rate of accrual may vary depending on the number of RTs set up. As a result the opportunity cost on account of delay in disposal of matters is expected to significantly reduce. Studies have shown positive impact of establishment of DRTs.[226]

*Benefits of alternative 1: Improvement in disposal rate, reduction in pendency and saving of opportunity cost. The benefits might vary depending on scenario*

*Alternative 2: E-governance in RTs*

The central government had launched an e-DRT project to significantly benefit from information and communication technology (ICT) interventions in RTs. E-governance of RTs comprised putting in place a state of art information technology system to provide parties hassle free access to intervention, publication of timely and accurate MIS reports, efficient case management, case tracking, availability of technological and state of art tools for recovery, and provision for hassle free administrative services.[227]

It is suggested that the e-DRT project be revived and efforts be made to benefit from information technology.

*Cost of alternative 2*

News reports have indicated high costs of e-DRT project, of around ₹200 crore (around ₹5.25 crore per RT). This was one of the reasons for the government putting on hold the plan.[228] Even if the e-DRT is project is implemented in phased manner of around three years, the annual expenditure is estimated to be around 67 crore.

*Cost of alternative 2:₹200 crore*

*Benefits of alternative 2*

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[226] "*I find that the establishment of tribunals reduces delinquency in loan repayment by between 3 and 11 percent. The effect is statistically significant within loans as well: for the same loan, installments that become due after the loan becomes treated are more likely to be paid up on time than those that become due before. Furthermore, interest rates on loans sanctioned after the reform are lower by 1.4-2 percentage points. These results suggest that legal reform and the improved enforcement of loan contracts can reduce borrower delinquency, and can lead banks to provide cheaper credit*", Visaria, *Legal Reform and Loan Repayment: The Microeconomic Impact of DRTs in India*, Boston University, April 2006.
[227] See, National Institute of Smart Governance, e-drt system in DRT an DRAT, at: http://nisg.org/project/37
[228]Remya Nair *et al*, *Plan to computerize debt recovery tribunals put on hold*, Livemint, July 28, 2013, available at: *http://www.livemint.com/Politics/FKQ3PvHgfnwmZQ2Z2DjuIN/Plan-to-computerize-debt-recovery-tribunals-put-on-hold.html*

Estimated benefits of the e-DRT project include increase efficiency, improvement in recovery rate and reduced delays in decision making. Studies have indicated that use of technology in courts have the potential to improve court performance to a significant extent.[229]

*Benefits of alternative 2: Improvement in disposal rate, reduced pendency and saving of opportunity cost*

### *2.3. Performance of adjudicatory officers and staff*

*Alternative 1: Revision of eligibility criteria*

It is suggested that eligibility criteria for adjudicatory officers and staff (registrars, recovery officers, etc.) be revised. In case of adjudicatory officer, a requirement of minimum experience of practice in banking/debt recovery; or qualifications suggesting knowledge in banking/ debt recovery could be included in the selection criteria. A written test might be conducted to ascertain the knowledge in these areas. Similarly, in case of staff of RTs, adequate educational qualifications or expertise, in form of legal and banking background, could be prescribed for selection. However, to avoid delays in selection procedure, a time limit must be prescribed within which the selection procedure must be completed. Alternative 1 would require amendments in Sections 5 and 10 of the DRT Act. In addition, an additional provision in the DRT Act requiring government to ensure adequate staff at DRT would need to be inserted.

*Costs of alternative 1*

Alternative 1 is expected to impose administrative costs in the process of selection of candidates. In addition, in order to complete the selection procedure within the prescribed time frame, additional officers might have to be deputed for RTs. Table 6.1 below provides a snapshot of staff at RTs and their respective remuneration.

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[229] Byrne *et al*, New Technology and Courts: Does IT have an Impact on Court Performance, American Judges Association, September 24, 2013, observes, "*Use of new technology results in 25 percent faster civil court case processing*." Also, Talukdar, e-Courts, The Renaissance in Indian Judiciary, available at: http://kamrupjudiciary.gov.in/documents/ecourts.pdf, "*Normally People have a blind view about District Courts being slow, rigid and secretive. Information & Communication Technology (ICT) can help us change this impression and Courts can become more efficient, fast, responsible and user friendly*". Justice Bharuka, *E-governance in Indian Judiciary*, available at: http://justicebharuka.in/file/Article%20-%20NJA%20IT%20and%20Law.pdf, notes "*The 124th Report of the Law Commission of India (1988) as also the expert studies recently made for improving the performance of the Indian Judicial System like the Indo-US Group Study (1996), Report of the India Institute of Management, Bangalore prepared pursuant to a reference made by the First National Judicial Pay Commission, Malimath Committee on Criminal Justice Reforms (2003) and the Final Report of the Asian Development Bank on India Administration of Justice Project (2004) conclusively reflect that use of information and communication technology in the judiciary has become imperative for enhancing the quality of justice, reducing congestion in courts and timely disposal of cases*". However, Justice Bharuka further notes, "*mere dumping of computer systems in the courts across the country is not automation or computerisation or implementation of IT and e-governance in judiciary.*" The Integrated Court System in Malaysia has enhanced efficiency and productivity of courts, resulted in speeding up disposal of cases, provided convenience and transparency to users of courts, and saved costs and time for courts and users, Azmi, *Using technology to improve court performance: Malaysia's experience,* Asia Pacific Judicial Reform Forum, October 26, 2010, available at: http://www.apjrf.com/Beijing_Malaysia.pdf

**Table 6.1: Staff at RTs**

| Position | Approximate salary (in ₹) |
|---|---|
| Secretary/Registrar | 58,984 |
| Assistant Registrar | 56,614 |
| Recovery Officer | 56,614 |
| Section Officer | 34,943 |
| Private Secretary | 34,943 |
| Assistant | 33,995 |
| Accounts Assistant | 33,995 |
| Recovery Inspector | 33,995 |
| Steno Grade 'C' | 33,995 |
| Steno Grade 'D' | 20,012 |
| UDC | 20,012 |
| LDC | 17,827 |
| Total (monthly) (A) | 4,35,929 |
| **Total (annual)**(B= A*12) | **52,31,148** |
| **Total (44 RTs) (B*44)** | **23,01,70,512** |

One additional officer per RT with basic remuneration cost per officer per year of ₹6 lakh could be sufficient for managing the selection process.

*Costs of alternative 1:₹2.64 crore (44 RTs) (annual)*
*Indirect costs of alternative 1: Reasonable efforts to administer the revised selection process*

*Benefits of alternative 1*
The revised eligibility criteria are expected to improve the quality of adjudicatory officers and staff at RTs. Knowledge about banking and debt recovery is expected to aid in improvement of performance of RTs,[230]speedy disposal of matters, and passing of quality orders.[231]

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[230] The Merit Selection Process of Judges in US is a method of "*selecting judges chooses on the basis of their qualifications, not on the basis of political and social connections….Merit selection not only sifts out unqualified applicants, it searches out the most qualified*", American Judicature Society, *Merit Selection: the Best Way to Choose the Best Judges*, available at: *http://www.judicialselection.us/uploads/documents/ms_descrip_1185462202120.pdf*. The National Judicial Appointments Commission is also required to recommend judges on the basis of ability, merit etc. Further, Section 15M(2) of the SEBI Act provides that 'a person shall not be qualified for appointment as member of a Securities Appellate Tribunal unless he is a person of ability, integrity and standing who has shown capacity in dealing with problems relating to securities market and has qualification and experience of corporate law, securities laws, finance, economics or accountancy'

[231]215 Report of the Law Commission of India, *L. Chandra Kumar be revisited by Larger Bench of Supreme Court*, December 2008, "*In view of the enhanced minimum required qualifications of Chairman, Members – Judicial/Administrative, in particular, Administrative, and giving the status of Chief Justice of High Court to the Chairman, and that of Judges of High Court to Members – Judicial/Administrative, the best persons available in the judiciary and administration are now attracted and are being accordingly selected to occupy the respective posts, as mentioned above. The Tribunal is thus now manned by persons having vast experience in judiciary and administration, resulting not only into quick disposal of cases, but quality judgments as well. In the beginning*

*Benefits of alternative 1: Selection of better quality candidates and improvement in performance of RTs*

*Alternative 2: Provision of technical member at RTs*

As discussed earlier, the composition of RTs is one adjudicatory officer, with legal background. Consequently, in order to provide support to the existing adjudicatory officers, it is suggested that a provision for one technical member – having experience or expertise in banking and debt recovery, be made.

*Costs of alternative 2*

It is estimated that average basic annual remuneration of a PO/ Chairperson is around ₹15 lakhs. Parity in remuneration is expected between legal member i.e. PO/Chairperson and technical member on a RT. In addition, the government would have to incur cost in search and selection process of technical members.

*Direct costs of alternative 2: 6.6 cr. (44 RTs) (annual)*
*Indirect costs of alternative 2: Costs for search and selection of technical members*

*Benefits of alternative 2*

Reconstitution of RTs and existence of a technical member is expected to improve the quality of orders and increase efficiency of RTs.[232] In addition, high quality orders are expected to reduce the possibility of challenge of orders of DRTs and DRATs, consequently reducing the delay and litigation cost.

*Benefits of alternative 2: Improved quality of orders and reduction in challenge of orders of RTs*

*Alternative 3: Provision of performance linked incentives*

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*when the Act of 1985 came into being and cases came to be disposed of by the Tribunal, there may have been an impression that Members of the Tribunal may not be having legal expertise to deal with intricate questions of law and fact. With the advent of time, the situation has improved vastly and speedy and quality justice dispensed by the Tribunal has come for appreciation by all*".

[232] In the matter of *L Chandra Kumar v. Union of India* (Decision dated March 18, 1997), it was held, '*The contention that appointment of Administrative members to Administrative tribunals should be stopped cannot be accepted as a judicious mix of judicial members and those with grass-root experience would be better suited for the purpose of speedy and efficient discharge of justice….To hold that the Tribunal should consist only of judicial members would attack the primary basis of the theory pursuant to which they have been constituted. Since the Selection Committee is now headed by a Judge of the Supreme Court, nominated by the Chief Justice of India, we have reason to believe that the Committee would take care to ensure that administrative members are chosen from amongst those who have some background to deal with such cases.*' Also see, 215 Report of the Law Commission of India, *L Chandra Kumar be revisited by Larger Bench of Supreme Court,* December 2008, observing, '*The enactment of the Administrative Tribunals Act, 1985 opened a new chapter in the sphere of administering justice to the aggrieved Government servants in service matters. The Act provides for establishment of Central Administrative Tribunal and the State Administrative Tribunals. The setting up of these Tribunals is founded on the premise that specialist bodies comprising both trained administrators and those with judicial experience would, by virtue of their specialised knowledge, be better equipped to dispense speedy and efficient justice. It was expected that a judicious mix of judicial members and those with grass-root experience would best serve this purpose.*'

It is suggested that performance link incentive system be developed for adjudicatory officers and staff of RTs. Such system must assess the quality and quantity of orders passed for estimating the incentives. Transparent performance indicators would need to be developed against which the performance of adjudicating officers could be the assessed. One of the ways to assess the quality of orders is to track the number of orders getting appealed at the appellate authorities and the number of orders getting overturned.[233]
In addition, the term of office of adjudicatory officers and staff must be linked to their performance and subject to review every year. There must be provisions to censure/penalise/remove adjudicatory officers and staff, in case of continued unjustifiable non-performance/sub-optimal performance.

Such performance review must be conducted by a committee comprising government and experts. Such committee must follow principles of natural justice, and provide an opportunity of hearing to the concerned officer, before making a reasoned decision in relation to performance.

It must also be possible to vary the salary, allowances, terms and conditions of service of the PO and Chairperson, on the basis of recommendations of such expert committee, and reasons must be provided to the concerned officer should the terms and conditions of its service are proposed to be altered. Such officer must be given adequate opportunity of hearing and should such officer not agree to the revised terms and conditions, she should be allowed to leave the office, with adequate notice. The performance review committee must work in tandem with the selection process, and should there be a possibility of removal/resignation of existing officer(s), the selection process must kick in well in advance, to avoid delay in the decision making and disruption in smooth functioning of RTs.

Similarly, the incentive of the staff of RTs, especially registrars and ROs must be linked to performance. Specific time periods must be prescribed for completion of tasks, and the staff must be required to provide reasons for sub-par performance, including non-compliance with the statutory time limits.

Sections 13, 14, 15 of the DRT Act would have to be accordingly amended. Moreover, provisions with respect to performance review of officers of RTs and constitution of a performance review committee would have to be included in the DRT Act.

*Costs of alternative 3*
The performance review committee must include a mix of government and independent experts. It is proposed that Joint Secretary, Department of Financial Services, Nominee of Governor of Reserve Bank of India, and senior-most Chairperson of DRAT, be government representatives and three independent experts in the field of banking, management and judiciary be part of the performance review committee. The independent experts could be appointed on the basis of transparent selection process inviting applications from interested persons.

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[233] "*In some judicial systems, a judge's reversal rate might be a critical performance criterion, while in others more weight would be placed on how often a judge's opinions were cited by other courts or even on the political acumen exhibited by the judge in his opinions. It is a mistake to suppose that one performance criterion or set of such criteria should be applicable to all judges.*" Hon. Richard A Posner, *Judicial Behaviour and Performance: An Economic Approach*, 32 FLA. ST. U. L. REV. 1259 (2005).

The independent experts must be adequately compensated for the task of performance review. Basic annual compensation of around ₹12 lakh each member could be reasonable. In order to smoothly conduct aforementioned functions, the performance review committee would have to be supported by efficient staff. It is proposed that four dedicated officers be attached to the performance review committee. The annual basic remuneration cost of each such officer is expected to be around ₹6 lakh. In addition, physical and technological infrastructure cost will have to be incurred, for setting up of secretariat and make it operational.

*Direct cost of alternative 3: ₹60 lakh (annual)*

*Indirect cost of alternative 3: physical and technological infrastructure cost*

*Benefits of alternative 3*
Linkage of performance to incentives is expected to motivate adjudicatory officers and staff for improved performance, and in turn, reduce the delay and improve the disposal rate. Studies indicate that performance linked incentives improve quality of performance.[234]

*Benefits of alternative 3: Improvement in performance of RTs*

*Alternative 4: Public disclosure of performance*

In order to enable public scrutiny of the performance of RTs, it is necessary to put information in relation to performance of RTs in public domain.[235]

Consequently, it is suggested that every RT must be mandated to produce periodic reports having details of number of decisions made, the matters wherein mandatory time limit was not met, the reasons thereof, and the action plan to prevent failure to meet statutory timelines in future. The reasons for delay must also be mentioned in the reasoned order made by the adjudicatory officers.

For instance, in case the RT adopted civil suit procedure instead of summary procedure, it would be required to explain why it felt the need to adoption civil suit procedure. Unjustifiable use of civil suit procedure must invite negative marking in performance review. Similarly, stakeholder consultation revealed that insistence of RTs to approve settlement

[234] Choi *et al*, *Are Judges Overpaid: A Skeptical Response to the Judicial Salary Debate*, 2009, Journal of Legal Analysis, "*The public debate over the need to raise judicial salaries has been one-sided. Sentiment appears to be that judges are underpaid. But neither theory nor evidence provides much support for this view. The primary argument being made in favour of a pay increase is that it will raise the quality of judging. Theory suggests that increasing judicial salaries will improve judicial performance only if judges can be sanctioned for performing inadequately or if the appointments process reliably screens out low-ability candidates. However, federal judges and many state judges cannot be sanctioned, and the reliability of screening processes is open to question. An empirical study of the high court judges of the fifty states provides little evidence that raising salaries would improve judicial performance*." Many US states have Judicial Performance Commission, which evaluate judicial performance on factors, such as integrity; legal knowledge; communication skills; judicial temperament; administrative performance; and service to the legal profession and the public. Further, each evaluation includes a narrative with the recommendation stated as 'retain', 'do not retain', or 'no opinion'. Available at: *http://www.coloradojudicialperformance.gov/* last accessed on March 31, 2015.
[235] The FSLRC Working Group on Banking (2013) also make similar suggestions, "*Amend RDDBFI (1993) and SARFAESI (2002) to ensure reporting requirements by appropriate authorities for preparing annual reports which detail revenues received through filing fees, resource allocation, steps taken towards efficient functioning of the tribunals, statistical analysis of cases and workload, time taken to dispose cases, and reasons for delay.*"

terms have resulted in the delay in recovery.[236]Should an RT insist on approval of settlement terms, it must provide explanation on the necessity of its approval.

The periodic reports must also provide details of matters in which appeals were made to appellate bodies and the number of decisions, which were overturned. An assessment in relation of kind of decisions overturned must be provided in the periodic reports. The periodic reports must be available in soft copy in public domain, and in hard copy, subject to payment of minimum fee. In addition, number of matters disposed of and pending; and the number of matters in which the statutory time limit was not met, could be released in public domain on a quarterly basis.

Greater transparency and public disclosure of information on the part of RTs would require an enabling provision in the DRT Act, mandating the same. In addition, performance related disclosure of staff of RTs must be made in the annual reports of RTs. Appropriate amendments in the DRT Act must be made in this regard.

*Cost of alternative 4*
In order to enable preparation of quarterly and annual reports, it is suggested that a dedicated officer at each of the RTs be appointed. Basic annual remuneration of each such officer could be estimated at around ₹6 lakh. Additionally, basic information technology infrastructure would be needed to put in place to ensure that performance reports are published in public domain.[237]

*Direct costs of alternative 4:₹2.64 crore (44 RTs) (annual)*

*Indirect costs of alternative 4: Basic information communication technology infrastructure cost*

*Benefits of alternative 4*
As discussed earlier, greater transparency and public disclosure of performance related information is expected to improve public scrutiny and accountability of adjudicatory officers and staff of RTs.

*Benefits of alternative 4: Improved accountability and disposal rate at RTs*

### *2.4. Process of filling vacancies*

*Alternative 1: Reforming the selection committee*

It is proposed that in addition to two regulators and three government officials of the existing selection committee, three independent part-time experts in banking/ debt recovery be part of the selection committee for selection of POs and Chairperson. The decisions of selection

[236]M R Umarji, Prioritise secured creditors claims, Economic Times, May 12, 2010, observes, "*When banks arrive at settlements with borrowers for repayment of banks dues, consent orders are to be obtained from debt recovery tribunals (DRTs) in pending recovery proceedings in terms of the settlement. Some DRTs have taken a stand that only they can approve such settlement terms and banks have no powers to finalise the settlement terms. It is necessary to amend the law to bring it in conformity with the provisions of the Civil Procedure Code that requires the court to pass orders in terms of the settlement whenever the suit is settled out of court*".
[237] As on date, around 12 RTs have websites. See, List of DRTs/ DRATs, *http://financialservices.gov.in/banking/ListOfDRATsAndDRTS.asp?pageid=1*

committee will be required to be taken by majority with views of minority recorded separately. This would require an amendment in the DRT (Procedure for Appointment as Presiding Officer of the Tribunal) Rules, 1998 and DRAT (Procedure for Appointment as Chairperson of the Appellate Tribunal) Rules, 1998.

It must be noted that selection of appropriate adjudicatory officers and staff of RTs would require some time and by the time adjudicatory officers are selected, the setting up of additional RTs (as proposed earlier) would still be under process. Consequently, it is suggested that till the time the additional DRTs are not operational, the POs and staff recruited be attached to the existing RTs. To facilitate this, amendments in Sections 3 and 9 of the DRT Act would be required to enable more than one PO/Chairperson at a RT. Such amendments would also aid in efficiently managing transfers and postings of POs and in case a PO is facing overload of cases, another PO could be stationed at that RT for efficient handling of matters.

*Costs of alternative 1*

It is proposed that the independent part-time expert members be provided a compensation of ₹10,000 per meeting, in addition to the travelling and daily allowance per meeting at the highest rate admissible to group 'A' government servants.[238]Further, to fill future vacancies on time, the selection committee will be required to meet well in advance (at least three months) of arising of vacancy and begin the selection procedure to select PO/Chairperson to avoid any unnecessary delays and smooth functioning the requisite RTs. This would require a full functioning secretariat for selection committees, manned with appropriate staff. It is expected that this would require at least four officers having annual basic remuneration of around ₹6 lakh each.

*Direct costs of alternative 1:₹45,000 per meeting (members), i.e. ₹1.80 lakh (annual) (assuming four meetings)*

*Additional costs of alternative 1:₹24 lakh (secretariat) (annual)*

*Benefits of alternative 1*

Existence of selection committee with independent expert members in place will aid in selection of high quality candidates for the position of adjudicatory officers at RTs. Experts have recommended for balanced selection committees comprising government representatives as well as independent experts, for various judicial forums, including tribunals.[239]

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[238]Available at: Office Memorandum issued by the Government of India dated September 23, 2008 regarding travelling allowance rules – implementation of sixth pay commission, available on: *http://www.nitj.ac.in/News/TA%20RULES.pdf*

[239] Parliamentary Standing Committee on Human Resource Development, 225th Report on Education Tribunals Bill, 2010, observes "*The Committee is not convinced by the justification given by the Department. It believes that the composition of the Selection Committee should be a balanced one as it would be appointing the Chairperson and members of the National Tribunals who would be discharging an important task of adjudicating on disputes primarily related to educational matters. Therefore, adequate representation of the academia should be ensured in the Selection Committee, so that the basic spirit behind the proposed legislation is not defeated*" . The Selection Committee as prescribed under the National Judicial Appointments Commission Act, 2014 also includes two eminent persons, other than representatives from judiciary and government. The Financial Sector Legislative Reforms Commission also recommends a balanced selection committee for selection of members of Financial Sector Appellate Tribunal.

*Benefits of alternative 1: Improved selection procedure, increased possibility of selection of better quality candidates, resulting in the improvement in quality of personnel manning RTs*

*Alternative 2: Constitution of independent advisory body to recommend candidates*

It is recommended that a three member independent advisory body be constituted to recommend candidates to the existing selection committee for the purpose of appointment of adjudicatory officers at RTs. The advisory committee will recommend at least three candidates for each of the vacant position and the selection committee will have to choose from the given choices. This would require an amendment in the DRT (Procedure for Appointment as Presiding Officer of the Tribunal) Rules, 1998 and DRAT (Procedure for Appointment as Chairperson of the Appellate Tribunal) Rules, 1998.

*Costs of alternative 2*

It is proposed that the advisory committee be provided a compensation of ₹15,000 per meeting, in addition to the travelling and daily allowance per meeting at the highest rate admissible to group 'A' government servants.[240] The difference in compensation from alternative 1 is on account of the requirement to suggest higher number of candidates, as compared to alternative 1. In addition, to ensure filling of future vacancies on time, the advisory committee will be required to meet well in advance (at least 3 months) of arising of vacancy and begin the selection procedure to select PO/Chairperson to avoid any unnecessary delays and smooth functioning the requisite RTs. This would require a full functioning secretariat for selection committees, manned with appropriate staff. It is expected that this would require at least three officers having annual basic remuneration of around ₹6 lakh each. The difference in composition from alternative 1 is on account of the requirement to suggest higher number of candidates, as compared to alternative 1.

*Costs of alternative 2: ₹60,000 per meeting (members), i.e. ₹2.40 lakh annually (assuming four meetings per year)*

*Additional costs of alternative 2: ₹18 lakh (secretariat) (annual)*
*Indirect cost of alternative 2: Time costs of selection committee to select candidates from the suggested list*

*Benefits of alternative 2*

Alternative 2 will ensure a balance between independence and discretion in selection process. The existence of an independent advisory committee is expected to act without any prejudices or pressure from government, and hence, is expected to recommend most suitable names for the purpose of selection of adjudicatory officers.

*Benefits of alternative 2: Improved selection procedure of adjudicatory officers of RTs*

[240]Available at: Office Memorandum issued by the Government of India dated September 23, 2008 regarding travelling allowance rules – implementation of sixth pay commission, available on: *http://www.nitj.ac.in/News/TA%20RULES.pdf*

### *2.5. Adjournments and irregular hearing of matters*

*Alternative 1: Disclosure of reasons to litigants*

It is recommended that the adjudicating officers be mandated to provide specific reasons for every adjournment which is granted. In addition, a time limit must be prescribed within which the next hearing of the matter must be made necessary.[241]

Stakeholder consultations during the project revealed that often adjournments are taken by lawyers of litigants without the consent or awareness of litigants. To address this situation, a short-messaging-service facility could be provided to the litigants briefly providing the details of proceedings and the next date of hearing[242] (including the fact of adjournment sought and costs imposed on the parties). The litigants must be able to the access such facility on the basis of payment of fee, and additional details in relation to order of RT and progress of matter must be available on the web site of the relevant RT, accessible by the relevant party on keying the username and password provided to the party at the time of initiation of the matter.[243] Setting up of this service will require incurring significant initial capital cost, however, the service could be adequately priced to recover the cost, at least partially, from the consumers.

The practice of grant of the adjournments by adjudicatory officers must also be considered in the performance review. Insufficient reasons for grant of adjournments must result in negative marking. The annual report of RTs must also provide assessment of matters wherein the statutory number of adjournments was crossed, the period of adjournments, and average number of adjournments granted by the RT. Adoption of the aforesaid suggestions would require appropriate amendments Section 19(5A) of the DRT Act.

*Costs of alternative 1*

The public disclosure mechanism/SMS service suggested under alternative 1 is expected to require high information communication and technology infrastructure cost. However, such cost is expected to be met by the reasonable fee charged by the users of the proposed SMS service. In addition, adequate number of officers would have to be recruited to prepare the disclosure reports and ensure timely uploading on websites.

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[241] R Gandhi, Banks Recovery and Regulations: A synergy, Workshop for Judges of DRATs and Presiding Officers of DRTs, December 29, 2014, "*As per the RDDBFI Act, though the cases are to be disposed of within six months, in some cases, the next date itself is given after six months to one year*".

[242] Stakeholder consultations revealed that a similar facility is available at National Consumer Disputes Redressal Commission. Also see, SMS Service for case information through Unified National Core CIS for Advocates and Litigants, available at: *http://ecourts.gov.in/sirmaur/sms-service-case-information-through-unified-national-core-cis-advocates-and-litigants*, last accessed on March 31, 2015.

[243] The FSLRC Working Group on Banking (2013) notes, "*Indian courts have been slow in adopting information technology. While there has been some improvements in communication to the public through websites; there is no movement towards integrating the entire court process into an electronic form. Digitisation of court records and computerisation of registries would be beneficial in handling the huge backlog of cases. As an example, digitising the registry of the Supreme Court of India has been beneficial in reducing arrears and in facilitating docket management. The Law Commission of India (2009) also recommends a move towards e-filing of documents and video conferencing of proceedings as an effort to save time and costs. For efficient functioning of DRTs, adopting information technology would help in overall reduction of case backlog and would lead to greater efficiency*."

It is expected that around two officers per RT would be sufficient for carrying out the tasks prescribed under alternative 1. Basic annual remuneration of the each such individual could be reasonably estimated to be around Rs6 lakh per annum.

*Direct cost of alternative 1:₹5.28 crore (44 RTs) (annual)*
*Indirect cost of alternative 1: Information communication technology infrastructure*

*Benefits of alternative 1*
Increased public disclosure and information to litigants about the progress of the case, the costs imposed, and the next date of hearing are expected to check and rein the unhealthy practice of lawyers to take adjournments without the consent of litigants. This is expected to improve transparency, accountability,[244] reduce pendency and delays in disposal of matters at the RTs.

*Benefits of alternative 1: Improved transparency and accountability*

*Alternative 2: Increasing cost of adjournments to litigants*

At times, grant of adjournments is on account of litigants not being adequately prepared or adopting delaying tactics.[245] It is often been observed that the existing court fees regime does not deter litigants from filing false and vexatious claims or seeking adjournments to delay the proceedings. Litigants who prolong matters and abuse the court's process pay the same court fees as litigants who do not indulge in such practices. Experts have recommended that court fees should be related to the time consumed by the litigants in the conduct of their case.[246]

Consequently, it is recommended that the application fee in RTs be proportional to the number of hearings. As discussed in previous Chapters, adjournments are, more often than

[244] D R Parera, E-governance in Court System of Sri Lanka, "*There are potential benefits of e-court system, Inter alia accountability, transparency, impartiality and responsiveness of judicial procedures by the application of ICT.*" Also, Centre for Internet and Society, *The Role of ICT in Judicial Reform – An Exploration,* November 18, 2009, available at: [http://cis-india.org/internet-governance/blog/what-will-be-the-role-of-ict-in-indias-judical-reform-process](http://cis-india.org/internet-governance/blog/what-will-be-the-role-of-ict-in-indias-judical-reform-process), notes, "*It is of no doubt that ICT can reduce the duplicity of the paper world and make courts more green through electronic case filing and video conferencing. Online case filing systems can increase speed in which citizens can have their cases heard, and real time access to online repositories of legal information drastically expedites the case cycle*".

[245] The 253rd Report of the Law Commission of India, *Commercial Division and Commercial Appellate Division of High Courts and Commercial Courts Bill, 2015,* January 2015 observes, "*At present, adjournments are granted too frequently and there are no consequences for lawyers who unnecessarily delay the case. In fact, the present culture of charging fees per hearing incentivises lawyers to delay cases. With costs being imposed infrequently and bearing no relation to actual expenses in a case, litigants have little fear of being punished and frequently indulge in delaying tactics.*"

[246] The 253rd Report of the Law Commission of India reviewed the practice in Singapore wherein it observed, "*Court fees increase depending on the number of days taken up for hearing by the parties to the case. For example, no court fees are payable for the first three hearings, SGD 8000 is payable for the first five hearings, SGD 20000 for the first ten hearings and so on. The scale keeps increasing up to the tenth hearing and the court fee goes up to SGD 5000 per hearing from the eleventh hearing onwards…Pleadings can be struck out by the court at any stage of the hearing if such pleadings do not disclose any cause of action, are vexatious, delay fair trial, or amount to an abuse of process of the court*". Further, the 188th Report of the Law Commission of India on Proposals for Constitution of Hi-tech Fast Track Commercial Divisions in High Courts, December 2003, observes "*Kenyan courts are cracking down in inefficiency and laxity. Head of the High Court's Commercial Division, Judge Tom Mbalute, has proposed various steps, including the refusal to grant adjournments of cases set for hearing. Hearing of matters before the commercial courts could not be delayed unless lawyers for the parties are engaged in other matters in the Appeal Court, he said, and no adjournments would be permitted if the counsel were engaged before other judges or magistrates in the High Court or lower courts*" .

not, on account of trail failure (adjournment without any work done on the assigned date). The party responsible for trial failure must be made to pay an additional amount and adjournments beyond a reasonable minimum (say, two) must invite costs at increasing rate.

- *Option 1*

At present, the maximum application fee for matters at RTs is ₹1.5 lakh. A matter is supposed to run for not more than six months on payment of such fee. Any matter which runs for more than this period due to fault of litigants (including advocates) must attract higher application fee, say ₹1.5 lakh for additional six month period, to be paid up front.

*Costs of option 1*
On the basis of stakeholders' consultation, it has been estimated that litigants/ advocates are a cause of around 75 percent trail failures (see Table 5.3). Assuming an average pendency of around 10,000 cases (20 percent[247] of the total pendency) at any given point of time attracting application fee of ₹1.5 lakh (matters involving value of more than ₹1.5 crore),[248] and around 7,000 cases being pending for more than six months (around 70 percent), cases delayed on account of litigants would be around 5,000 (around 75 percent). Additional application fee of ₹1.5 lakh on such cases will result in consolidated cost of around ₹75 crore.

*Total cost of option 1:₹75 crore*

*Benefits of option 1*
Option 1 is expected to result in additional revenue generation for RTs, which could contribute significantly to RTs achieving financial independence. Judicially used, such additional revenue could help improving performance of RTs, improvement of disposal rate and reduction of delays.

In addition, the possibility of steep increase in cost of litigation, should the matter remain pending for more than six months is expected to make the litigants and advocates attentive and put best efforts to ensure disposal of matters within the six month timeline, thereby reducing pendency at RTs.

*Benefits of option 1: Increase in revenue of RTs, avoidance of delaying tactics by litigants, and reduction in pendency*

- *Option 2*

Additional cost on litigants could be mandatorily imposed at an increasing rate on the adjournments sought beyond a reasonable number. Consequently, it is suggested that beyond the statutorily allowed three adjournments, the cost for each additional adjournment should start with 0.1 percent of the value of the matter, doubling per adjournment. Such cost must be levied on only such matters, which attract maximum application fee of ₹1.5 lakh (matters valuing at least around ₹1.5 crore), to avoid excess cost on small-scale litigants.

*Cost of option 2*

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[247] *'80:20 Rule' or 'Pareto Principle'* states that 80 percent of outcomes can be attributed to 20 percent of causes for a given event.
[248] The application fee where the amount of debt is above 10 lakh is ₹12,000 plus ₹1,000 for every one lakh of debt or part thereof in excess of ₹10 lakh, subject to a maximum of ₹1.5 lakh.

Assuming the minimum value of matter at ₹1.5 crore the minimum cost of first additional amendment would be around ₹15,000 (0.1 percent). Assuming at least 20 percent of matters (around 10,000) have value of more than ₹1.5 crore and require at least one additional adjournment, the consolidated cost for one additional adjournment under Option 2 will be around ₹15 crore.

*Cost of option 2:₹15 crore (first additional amendment)*

*Benefits of option 2*

Option 2 is expected to result in additional revenue generation for RTs, albeit less than option 1. Judicially used, such amount could help in improving performance of RTs, thus improving disposal rate, and reducing pendency.

However, as the cost of the amendment is mere 0.1 percent of the value of matter, it is likely that it would be absorbed in litigation cost, and might not be as effective as Option 1 in stopping the practice of additional amendments.

*Benefits of option 2: Increase in revenue of RTs, avoidance of delaying tactics by litigants, and reduction in pendency*

## 3. Securitisation Act

***3.1. Taking of possession of secured asset by Magistrate***

*Alternative 1: Specific time period*

A specific time period could be proposed within which the Magistrate must be required to take possession of secured assets. As discussed in earlier chapters, the Bombay High Court had proposed a time limit of two months for the Magistrates in the state to take possession.[249] This would require amendment to Section 14 of the Securitisation Act.

*Cost of alternative 1*
This is not expected to impose significant additional costs on Magistrate, other than administration and management costs. However, the pressure of meeting the timelines might result in orders with limited application of mind. Therefore, it is suggested that the Magistrate be required to pass reasoned orders.

*Cost of alternative 1: Increase in administration and management costs of Magistrate*

*Benefits of alternative 1*

Existence of statutory time period is expected to ensure that the Magistrate issues orders for taking of possession of secured assets in a time bound manner, resulting in improved recovery process.

*Benefits of alternative 1: Taking over of possession by Magistrate within a specified time period*

[249] FSLRC Working Group on Banking (2013).

*Alternative 2: Right to secured creditor to approach DRT*

In case the Magistrate is not able to order taking over of possession within a reasonable time period, the secured creditor must be statutorily authorised to approach the DRT for directing the Magistrate to take over the possession at the earliest, and provide reasons for not doing the same within a reasonable time frame. This will require amendment to Section 14 of the Securitisation Act.

*Costs of alternative 2*
The possibility of secured creditor approaching DRT is expected to put pressure on Magistrate to order taking over of possession within a reasonable time frame, resulting in increase in its administration and management cost.

In addition, alternative 2 is expected to increase the number of matters filed at DRTs, thereby increasing the burden on RTs.

*Costs of alternative 2: Increase in administration and management costs of Magistrate and increase in burden on DRTs*

*Benefits of alternative 2*
As a result of alternative 2, the Magistrate is expected to issue orders of taking possession within a reasonable time frame, resulting in improvement in debt recovery.

*Benefits of alternative 2: Issuance of orders by Magistrate within a reasonable time frame resulting in improvement of debt recovery*

### *3.2. Challenge of measures taken under Securitisation Act*

*Alternative 1: Statutory pre-requisite for challenging action*

The applicant challenging action of the lender taken under Section 13 of the Securitisation Act must be statutorily required to explain and establish its *locus standi*, for admission of application at DRT. The Registrar and PO must be authorised to the summarily dispose of the application in case the applicant is not in a position to justify the damage done to itself, or potential damage either directly or indirectly, by the action taken under Section 13 of the Securitisation Act. Further, no adverse order must be passed by DRT before admission of the application challenging action under Securitisation Act.

*Costs of alternative 1*
Alternative 1 is expected to impose additional litigation cost on applicants under Section 17, as the applicants will have to make a strong case, with adequate evidence, should they want their application to be admitted at the DRT.

*Costs of alternative 1: Increase in litigation cost*

*Benefits of alternative 1*
Alternative 1 is expected to result in reduction of fraudulent applications made under Section 17. Consequently, the recovery process is not expected to be unnecessarily delayed.

*Benefits of alternative 1: Prevention of fraudulent applications and prevention of recovery process being stymied*

*Alternative 2: Statutory penalties in case of unjustifiable challenge*

In case DRT (Registrar/ PO) is of the opinion that the application made under Section 17 is fraudulent in nature and needs to be disposed of, a penalty could be statutorily imposed on the applicant. The applicants must be required to provide adequate details at the time of making an application, to establish its genuineness. In addition, the DRT should be required to provide reasons for its findings relating to fraudulent challenge and disposal of application.

*Costs of alternative 2*
Alternative 2 is expected to put reasonable burden on the litigants for providing evidence to prevent imposition of penalties in case the application is found to be fraudulent in nature. In addition, the alternative is expected to put reasonable costs on DRTs to scrutinise the applications in detail, for ascertaining genuineness of applications.

It is suggested that one officer per RT (as appeals could be preferred at DRATs) be appointed to assist the Registrar in ascertaining genuineness of applications. Basic remuneration cost per such officer could be estimated to be around ₹6 lakh per annum.

*Costs of alternative 2:₹2.64 crore (44 RTs) (annual)*
*Additional costs of alternative 2: Increase in litigation costs*

*Benefits of alternative 2*
The possibility of imposition of penalty is expected to reduce the inflow of fraudulent applications under Section 17, thus improving the recovery process. In addition, the levy of penalty is expected to result in additional source of revenue for RTs, which if judicially used, could aid in improvement of performance of RTs, consequently improving debt recovery.

*Benefits of alternative 2: Improvement in recovery and additional revenue generation for RTs.*

### ***3.3. Taking over of management***

*Alternative 1: Management fee to secured creditor*

It is suggested that in addition to the recovery of debt by the lender/ financial institution upon taking over of management, in lieu of putting in efforts in turning around of borrowers' business, the lender/ financial institution should be eligible to receive a management fee from the borrower. Should the borrower not be in a position to pay the management fee, the lender/ financial institution must be permitted to manage former's business for a reasonable time to recover the management fee. The management fee could be set as a specific percentage of debt due.

*Costs of alternative 1*
Alternative 1 is expected to impose additional financial burden on borrowers. In addition to repayment of the debt due, they would be required to pay management fee on account of turnaround of their business. In addition, this might result in delayed repossession of the secured asset to borrower.

*Costs of alternative 1: Additional financial burden on the borrower. In addition, possibility of delay in repossession of secured asset*

*Benefits of alternative 1*
The provision of management fee, over and above the due amount is expected to motivate the lenders/financial institutions to resort to this mechanism for recovery of debt. This, in effect, is expected to improve the rate of debt recovery.

*Benefits of alternative 1: Greater usage of this mechanism of debt recovery resulting in improvement in debt recovery*

*Alternative 2: Expansion of scope of debt*

It is suggested that the scope of debt be expanded to include cost of turnaround of borrowers' management by secured creditor. Recovery of such cost will be accorded priority over the original debt due to the secured creditor, from the amount recovered pursuant to taking over of management.

*Costs of alternative 2*
Alternative 2 is expected to impose additional financial burden on borrowers. In addition to repayment of the debt due, they would be required to reimburse the cost of turnaround of their business. In addition, this might result in delayed repossession of the secured asset to borrower.

*Costs of alternative 2: Additional financial burden on the borrower. In addition, possibility of delay in repossession of secured asset.*

*Benefits of alternative 2*
The provision of recovering the cost of turnaround of borrowers' management, over and above the due amount is expected to motivate the lenders/ financial institutions to resort to this mechanism for recovery of debt. This, in effect, is expected to improve the rate of debt recovery.

*Benefits of alternative 2: Greater usage of this mechanism of debt recovery resulting in improvement in debt recovery*

### *3.4. Provisions to determine correct valuation of secured asset*

*Alternative 1: Transfer of financial assets amongst securitisation/reconstruction company*

As present, the Securitisation Act does not allow transfer of rights or interest in financial assets by a securitisation/reconstruction company to other. This hinders ascertainment of correct valuation of the security. It is suggested that such restriction be removed from the legislation.[250] However, in order to prevent circular transactions amongst securitisation/

[250] "*In many countries the Asset Management Companies (AMCs) failed because the creation of AMCs did not lead to the development of a market for NPLs. Such a market is typically missing in less developed countries because information asymmetries and a lack of creditor coordination make it very difficult to price NPLs…. The development of a NPA market can, therefore, be hardly overemphasised*".

reconstruction companies, public disclosure in relation to valuation methodology must be mandated.

*Costs of alternative 1*
Alternative 1 might increase the cost of securitisation/ reconstruction of financial assets and the requirement of the public disclosure of valuation methodology might result in imposition of additional burden on such entities.

*Costs of alternative 1: Increase in the cost of securitisation/ reconstruction for securitisation/ reconstruction companies*

*Benefits of alternative 1*
Alternative 1 is expected to result in ascertainment of correct valuation of secured asset and improve the realisation of secured creditor. In addition, it is expected to create viable market for transfer of the secured assets, and interest therein, resulting in increase in competition and specialisation in the securitisation/ reconstruction market.

*Benefits of alternative 1: Increased recovery for secured creditor and the development of market for secured interests*

*Alternative 2: Insertion of general guiding principles in the SARFAESI Act*

General guiding principles in relation to valuation of the secured assets could be inserted in the Securitisation Act. These could comprise requirement of arm-length transactions, transparency, and valuation on the basis of market value, etc.

*Costs of alternative 2*
Alternative 2 is expected to impose costs on securitisation/ reconstruction companies as they would need to ensure compliance with the principles mentioned in relation to valuation under the Securitisation Act. In order to determine true value of secured, greater efforts might be required in relation to due diligence, engagement with expert valuers, etc.

*Costs of alternative 2: Imposition of additional costs on securitisation/ reconstruction companies in order to ascertain correct valuation of secured asset*

*Benefits of alternative 2*
Alternative 2 is expected to help improve transparency and accountability in the securitisation/ reconstruction market. In addition, it is expected to improve the returns to the secured creditor and prevent vested arrangements between securitisation/ reconstruction companies and borrowers.

*Benefits of alternative 2:* Greater transparency and accountability in the securitisation/ reconstruction market, and greater returns to the secured creditors.

### *3.5. Registration of security interest*

*Alternative 1:* According priority to security interest from the date of registration.

As discussed in previous chapters, while it is currently compulsory to register creation, change and satisfaction of security interest with the Central Registry, priority of claims is not based on the date of registration. Consequently, there seems to be no perceived benefit of registration. It is suggested that the security interests be accorded priority on the basis of date of registration.

*Costs of alternative 1*
The possibility of loss of priority on failure to register/ possible benefit on timely registration of security interest is expected to nudge the SC/ RC/ secured creditors to register the security interest. However, increase in cost[251] is not expected to be significant given hitherto, the possibility of penalties on failure to register security interest would have motivated SC/RC/ secured creditors to register security interest. The increase in registration of security interests is also expected to put additional burden on the Central Registry, and it might require additional resources to manage the increase in registration.

*Costs of alternative 1: Minimal increase in costs to securitisation/ reconstruction companies. Reasonable increase in costs to Central Registry to manage increased flow of registration applications*

*Benefits of alternative 1*
Priority of claims on the basis of registration is expected provide clarity, in case of dispute, and is also expected to make the Central Registry much useful, in addition to providing the existing benefits, such as search and inspection of claims.[252] This is also expected to bring with the international best practice with respect to the central repository of secured interests.

*Benefits of alternative 1: Greater clarity with respect to priority of claims in registration of security interest improving the possibility of recovery*

*Alternative 2: Making penalties proportional to the amount of security interest*

The current system seems be disproportionate to small value transactions while have to register with the Central Registry merely to avoid severe penalties, with limited consequent benefits. Also, the capacity of Central Registry to impose such penalties also seems to be limited. Thus, it is suggested that the penalties on delay in registration under the Securitisation Act be made proportional to the value of security interest.

*Costs of alternative 2*
Alternative 2 is expected to increase the possibility of imposition of additional costs on parties dealing with high value securities, should they fail to register the transaction within the specified time period. The loss of income to Central Registry from reduction in penalty on small value transactions is expected to be compensated by increase in penalty on high value transactions

*Costs of alternative 2: Increased possibility on imposition of higher penalties on parties engaging in high value transactions, should they fail to register the secured interest*

*Benefits of alternative 2*

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[251] The registration fee is modest, within the range of ₹50-₹1,000, under the SARFAESI (Central Registry) Rules, 2011, for different transactions requiring registration.
[252] *https://www.cersai.org.in/CERSAI/JSP/index.jsp*

Alternative 2 is expected to provide relief with parties dealing with small value of secured interest on account of reduction in amount of penalty should they delay the registration of security interest.

In addition, the Central Registry will have the freedom to focus on high value transactions and ensure their timely registration. This is also expected to improve the capacity of Central Registry to impose penalties on defaulting parties.

*Benefits of alternative 2: Reduction in cost of small value transactions and focussed efforts of Central Registry*

## 4. Common Issues

Some of the impediments to debt recovery under DRT Act and Securitisation Act are common. These include delay in disposal of applications by RTs, exercise of jurisdiction by other judicial forums, and absence of clarity on priority of claims of creditors under respective Acts. Statutory alternatives with respect to relevant provisions under the DRT Act and Securitisation Act are discussed below:

### *4.1. Time limit for disposal of matters*

*Alternative 1: Provision for mandatory time limit with reimbursement of application fees on non-compliance*

It is suggested that Sections 19 and 20 of the DRT Act and Section 17 of the SARFAESI Act be amended to provide for mandatory time-limits for disposal of matters by RTs. To ensure compliance with such suggestion, it is proposed that in cases where the mandatory time limits are not complied with by the adjudicatory officers, the application fees be reimbursed to the concerned party.

*Costs of alternative 1*

The minimum application fee chargeable for filing an application under the DRT Act is ₹12,000.[253] Assuming that of 28,258 cases referred to DRTs in fiscal 13-14,[254] around 20,000 matters are not expected to be disposed of within the six-month period[255], the minimum refundable application fee would be around ₹24 crore. This is close to 25 percent of the annual allocation for RTs for fiscal 15-16.[256] Consequently, the financial position of RTs is expected to have severe adverse impact as a result of alternative 1. The consequent resource constraints at RTs could result in further sub-optimal performance by RTs.

*Estimated direct cost: ₹24 crore (annual)*

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[253] Debt Recovery Tribunal (Procedure) Rules, 1993

[254] Statistical tables relating to banks in India, Reserve Bank of India, available at http://dbie.rbi.org.in/OpenDocument/opendoc/openDocument.jsp

[255] Raghuram Rajan, *Saving Credit*, Verghese Kurien Memorial Lecture, November 25, 2013, notes, "*even though the law indicates that cases before the DRT should be disposed off in 6 months, only about a fourth of the cases pending at the beginning of the year are disposed of during the year – suggesting a four year wait even if the tribunals focus only on old cases. However, in 2013-14, the number of new cases filed during the year was about one and a half times the cases disposed of during the year. Thus backlogs and delays are growing, not coming down*".

[256] Union Budget 2015-16 allocates around ₹100 crore for RTs.

*Estimated indirect cost (additional): Sub-optimal performance by RTs*

*Benefits of alternative 1*

The benefit of alternative 1 would be refund of court fee. Assuming an average pendency of around two years,[257] refund of application fee on crossing of six month period is estimated to save the opportunity cost for litigants. In addition, the fear of reimbursement of application fee could improve the disposal rate of matters by RTs.

*Estimated direct benefit: ₹24 crore (annual)*

*Estimated indirect benefit: ₹3 crore (opportunity cost saved annually)*

*Estimated indirect benefit (additional): Improvement in disposal rate*

*Alternative 2: Public disclosure of non-compliance with time limits and reasons thereof*

In order to improve accountability and enable public scrutiny of performance of RTs, it is suggested that RTs make public disclosure of non-compliance with time limits and the reasons thereof, on a quarterly basis, in form of reports, on their websites.[258] Further, submission of such performance related information should be mandatorily submitted to a select committee of Parliament, which should be in a position to inquire reasons of non-compliance from RTs. This will serve as performance check of RTs. Consequent amendments would be required in Sections 19 and 20 of the DRT Act and Section 17 of the SARFAESI Act.

*Costs of alternative 2*

In order to collect and collate relevant information and prepare reports for uploading at websites of RTs and submission to a select committee of Parliament, a dedicated officer would be required at each of the RTs. Estimated annual basic remuneration for such officer is estimated to be around ₹6 lakh.[259] In addition, significant information, communication and technology costs would need to be incurred for putting in place websites and processes to upload relevant reports.

*Estimated direct costs:₹2.64 crore (44 RTs)[260](annual)*
*Estimated indirect costs: Information, communication and technology costs*

*Benefits of alternative 2*

Scrutiny by public and a select committee of Parliament following such disclosure of information is expected to improve efficiency of RTs and reduce the time taken to dispose of

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[257] Estimating the annual disposal rate of around 25 percent , also validated during project

[258] Justice M Jagannadha Rao (Retd.), *Report of the Task Force on Judicial Impact Assessment*, June 15, 2008, available at: http://lawmin.nic.in/doj/justice/judicialimpactassessmentreportvol1.pdf, "*The public has a right to know what to expect from the court system. If there is delay in the disposal of cases, then they are entitled to know the reasons for the same.*" Also, The observation made by FSLRC working group on Banking (2013) is worth noting here, "*the laws of these countries [US, UK, Australia] also have provisions on budgeting, preparing annual reports and analysing statistics relating to workload and pending cases. The courts and tribunals also have a duty to ensure efficient services are provided to the users.*"

[259] Annual approximate salary of a Section Officer at RT is around ₹4.2 lakh and of a RO is around ₹6.6 lakh

[260] Currently, there are 33 DRTs and 5 DRATs. The government is in the process of setting up 6 additional DRTs

matters. Further, it is expected that public disclosure of the performance related information will improve efficiency of RTs, resulting in increase in disposal of matters.

Studies indicate that public disclosure of information enhances public confidence on justice system, enables people to make better decisions about preferred dispute resolution mechanism. Such system also creates more efficient judicial system by availability of information with government to make better policy decisions.[261]

*Estimated benefits: Greater public scrutiny of RTs performance, increase in disposal rate, improvement in efficiency and saving of opportunity cost for litigants.*

***4.2. Exercise of jurisdiction by other courts/judicial authorities***

*Alternative 1: Public disclosure of matters pending on account of orders of other courts/ judicial authorities*

Details of matters which are pending are RTs on account of orders of other courts/ judicial authorities must be public, in form of quarterly and annual reports. The details must include the party approached the other judicial authority, summary of the order, the period for which the matter is pending since the order of other judicial authority, the amount involved in the matter, whether the action is under DRT Act or Securitisation Act. This would require amendments in DRT Act and Securitisation Act.

*Cost of alternative 1*

In order to collect information in relation to matters pending on account of orders of other judicial authority and prepare periodic report, one officer per RT seems to be sufficient. Average annual basic remuneration of one such officer is expected to be around ₹6 lakh. In addition, information communication technology infrastructure would be required to put in place for implementation of alternative 1.

*Direct cost of alternative 1: ₹2.64 crore (44 RTs) (annual)*

*Indirect cost of alternative 1: Information communication technology infrastructure cost*
*Benefits of alternative 1*

As discussed earlier, public scrutiny of details of matters pending at RTs, including details of matters pending on account of orders of other judicial authorities/courts is expected to dissuade litigants from approaching other judicial forums. Consequently, the instances of the other judicial authorities exercising jurisdiction are expected to reduce.

*Benefits of alternative 1: Reduction in the practice of approaching other judicial forums*

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[261] Management of court information, Ministry of Justice, Government of New Zealand, available at: http://www.justice.govt.nz/publications/global-publications/r/regulatory-impact-statement-review-of-the-judicature-act-and-consolidation-of-courts-legislation/2-management-of-court-information, last accessed on 27 March 2015, Also see, World Bank Working Paper, *Access to Information and Transparency in Judiciary*, 2010, "*The dissemination of court statistics would help citizens learn about the true performance of the courts and at the same time generate opportunities for academia and NGOs to analyse the challenges and to formulate reform proposals. In this case, a virtuous cycle is generated through the feedback between access to judicial information, monitoring and analysis by civil society, and accountability by the judicial institutions. In turn, access to information and transparency reforms are also relevant since they can contribute to the improved operation of the Judicial Branch and hence foster inclusive governance*".

*Alternative 2: Penalising the party approaching other courts/judicial authorities*

Should a party approach an alternative judicial forum when a matter is pending at RT, a penalty could be imposed on such party by the relevant RT. The penalty could be in proportion to the amount involved in the matter. The penalty could be imposed on only such matters wherein the maximum application fee of ₹1.5 lakh has been levied.

*Cost of alternative 2*

Assuming the total numbers of matters having value of at least ₹1.5 crore (attracting application fee of ₹1.5 lakh) around 10,000 and that around 10 percent of such pendency is on account of interference of other judicial authorities, a levy of around ₹1 lakh per such matter is expected to cost around ₹10 crore to litigants.

*Cost of alternative 2:₹10 crore*

*Benefits of alternative 2*

Possibility of imposition of penalty on approaching other judicial forums is expected to dissuade litigants from approaching other judicial forums. This is expected to reduce the interference of other courts/judicial authorities in matters pending at RTs.

*Benefits of alternative 2: Reduced interference of courts/other judicial authorities*

While this chapter analysed statutory alternatives to select provisions of DRT Act and Securitisation Act, and estimated costs and benefits thereof, the next chapter compared such alternatives and recommends such statutory alternatives having the potential to achieve maximum net benefit.

# *Chapter 7:*
# Selection of Alternatives

## 1. Background

In the previous chapters, the impacts of existing sub-optimal provisions/ absence of provisions have been estimated and the statutory alternatives with respective costs and benefits have been highlighted. This chapter compares select alternatives in order to recommend the most suitable alternative, having the potential to achieve maximum net benefit to the society.

## 2. DRT Act

### *2.1. Threshold for filing applications at DRTs*

Table 7.1 compares the baseline scenario with respect to threshold of filing applications and the suggested alternatives

**Table 7.1: Threshold for Filing Applications at DRTs**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | Minimum threshold for matter: ₹10 lakh<br>Minimum application fee: ₹12,000 | Revised threshold of matters: ₹ 25 lakh<br>Revised minimum application fee: ₹30,000<br>Amendment to DRT Act to put threshold limit in Schedule, subject to change by executive order | Power to central government to determine the threshold limit in Rules, on the basis of RIA, from time to time |
| Costs | High pendency at RTs on account of high small value claims | Increase in opportunity cost of potential applicants who will not be in a position to pay the increased application fee of ₹30,000 or with matters valued below ₹25 lakh, and have to approach alternate judicial forums/ adopt other measures for debt recovery | No immediate impact but cost to undertake RIA to change threshold value |
| Benefits | Similar treatment to all claims, irrespective of the amount involved | Reduction in pendency and focus on high value claims | No immediate impact but benefit of arriving optimal threshold value on the basis of RIA |

*2.1.1. Recommendation*

**Table 7.1** reveals that alternative 2 is not expected to change the baseline scenario (unless the government decides to amend the threshold limit after an in-depth RIA). The benefits under alternative 1, of reduced burden on RTs, focus on high value claims seems to outweigh its costs, i.e. probable estimated costs to potential low value litigants. Consequently, adoption of alternative 1 is recommended. This would require amendment in Section 1(4) of the DRT Act, and insertion of a Schedule.

### *2.2. Number of RTs*

Table 7.2 compares the baseline scenario with respect to the number of RTs and the suggested alternatives

**Table 7.2: Number of RTs**

| **Particulars** | **Baseline** | **Alternative 1** | | **Alternative 2** |
|---|---|---|---|---|
| | | Scenario 1: High pendency | Scenario 2: Low pendency | |
| Description | 39 DRTs[262] and 5 DRATs | Establishment of 73 additional DRTs | Establishment of 24 additional DRTs | E-governance in RTs |
| Costs | Low efficiency, high pendency, low disposal rate | ₹192 crore, additional infrastructure cost | ₹63 crore, additional infrastructure cost | ₹200 crore |
| Benefits | Low administration cost | Significant reduction in pendency and significant increase in disposal rate | Reasonable reduction in pendency and reasonable increase in disposal rate | Improvement in performance |

*2.2.1. Recommendation*

Table 7.2 reveals that while scenario 1 under alternative 1 and alternative 2 are expected to impose significant costs, the consequent benefits of the former are expected to be greater than the latter. However, scenario 2 is expected to impose modest cost with reasonable benefits. Implementation of scenario 1 in a phased manner of around three years would be akin to implementation of scenario 2. Consequently, it is recommended that suggestions under scenario 2 of alternative 1 be implemented, subject to review of impact, after one-year period. This would require insertion of an enabling provision in DRT requiring government to ensure adequate number of RTs in the country.

### *2.3. Performance of adjudicatory officers and staff*

**Table 7.3** compares the baseline scenario with respect to the performance of adjudicatory officers and staff and the suggested alternatives

[262] Supra Note 265

**Table 7.3: Performance of Adjudicatory Officers and Staff**

| Particulars | Baseline | Alternative 1 | Alternative 2 | Alternative 3 | Alternative 4 |
|---|---|---|---|---|---|
| Description | Sub-optimal eligibility criteria<br>One PO/ Chairman per RT<br>No performance review or performance linked incentives<br>No public disclosure of performance | Revision of eligibility criteria to include experience/ knowledge in banking/debt recovery | Provision of technical members at RTs | Provision for performance linked incentives for adjudicatory officers and staff, by a performance review committee | Periodic public disclosure of performance |
| Costs | Sub-optimal performance, high pendency, low disposal rate | Salary: ₹2.64 crore (annual)<br>Reasonable efforts to administer the revised eligibility criteria | Salary: ₹6.6 crore (annual)<br>Costs in search and selection of technical members | Salary: ₹60 lakhs (annual)<br>Significant physical and infrastructure cost | Salary: ₹2.64 crore (annual)<br>Basic information communication technology infrastructure cost |
| Benefits | Low administration cost | Selection of better quality candidates and improvement in performance | Improved analysis and quality of orders, reduction in pendency and reduction in challenge rate | Increased motivation for better performance, improvement in quality | Increased public scrutiny of RTs performance, and improvement in accountability |

*2.3.1. Recommendation*

Comparison of costs and benefits of different alternatives as listed in Table 7.3 reveals that net benefits of alternative 2 are expected to surpass the net benefits under any other alternatives. While alternatives 1 and 3 deal with the issue of quality and quantity at RTs, alternatives 2 and 4 deal with issues of both quality and quantity. While alternative 4 is expected to put external pressure to improve performance, alternative 2 attempts to deal with the problem from within. Consequently, adoption of alternative 2 is recommended. This would require amendment in Sections 4 and 9 of the DRT Act.

### *2.4. Process of filling vacancies*

Table 7.4 compares the baseline scenario with respect to process of filling vacancies and the suggested alternatives.

**Table 7.4: Process of Filling Vacancies**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | Selection committee comprising government representatives | Inclusion of part time experts in selection committee | Constitution of independent advisory body to recommend candidates |
| Costs | Sub-optimal quality of adjudicatory officers, resulting in low quality orders and high pendency | Salary cost: ₹25.80 lakh (annual)<br>Reasonable efforts to implement the revised selection process | Salary cost: ₹20.40 lakh (annual)<br>Reasonable time costs in search, recommendation and selection of candidates |
| Benefits | Low administration cost | Reasonable possibility of selection of better quality candidates and improvement in RTs performance | Reasonable possibility of selection of better quality candidates and improvement in performance of RTs |

*2.4.1. Recommendation*

Comparison of alternatives under Table 7.4 suggests that the net benefits of alternative 2 are expected to surpass the net benefits of alternative 1. This is because the independent advisory committee is expected to work without any pressure from the government, and is expected to recommend high quality candidates, from whom the government would be bound to make selection. Consequently, adoption of alternative 2 is recommended. This would require amendment in Section 5, 10, 14 of the DRT Act and the corresponding rules made thereunder.

### *2.5. Adjournments and irregular hearing of matters*

**Table 7.5** compares the baseline scenario with respect to adjournments and irregular hearing of matters and the suggested alternatives

**Table 7.5: Adjournments and Irregular Hearing of Matters**

| Particulars | Baseline | Alternative 1 | Alternative 2 | |
|---|---|---|---|---|
| Description | Non-compliance with the statutory prescribed limit on adjournments | Disclosure of adjournment, reason and cost to litigants[263] through SMS facility | Increasing cost of adjournments to litigants | |
| | | | *Option 1:* Increasing application fee for matters running beyond six months | *Option 2:* additional cost for grant of adjournment at increasing rate (0.1 percent of matter) beyond reasonable |

[263] Not lawyers

| Particulars | Baseline | Alternative 1 | Alternative 2 | |
|---|---|---|---|---|
| | | | | number |
| Costs | Sub-optimal performance, high pendency, low disposal rate | Salary cost:₹5.28 crore (annual)<br>High information communication technology infrastructure cost | Cost to litigants due to increased application fee: ₹75 crore | Cost to litigants for first additional amendment: ₹15 crore |
| Benefits | - | Reduction in the practice of lawyers taking uninformed adjournments, reduction in pendency and improvement in disposal rate | Significant increase in revenue generation for RT resulting in improved financial independence, avoidance of delaying tactics by litigants | Reasonable increase in revenue generation for RTs resulting in improved financial independence, avoidance of delaying tactics by litigants |

*2.5.1. Recommendation*

A comparison of different alternatives under Table 7.5 would reveal that net benefits under option 2 of alternative 2 are expected to surpass the net benefits under other alternatives. The high costs under option 1 under alternative 2 might not result in commensurate benefits however, under option 2, the defaulting litigants are expected to directly feel the adverse impact of increased cost of additional amendments, resulting in reduction in the practice of delaying the matters. Consequently, adoption of option 2 of alternative 2 is recommended. This would require amendments to Section 19(5A) of the DRT Act.

## 3. Securitisation Act

### *3.1. Possession of secured asset by Magistrate*

Table 7.6 compares the baseline scenario with respect to possession of secured assets by Magistrate under SARFAESI Act and the suggested alternatives

**Table 7.6: Possession of Secured Assets by Magistrate under SARFAESI Act**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | No specific time period for the Magistrate to take possession under the SARFAESI Act | Specific time period within which the Magistrate will be required to take possession under the SARFAESI Act | Specific provision in the SARFAESI Act authorising secured creditor to approach RTs to direct Magistrate to take possession, and justify the delay, in case the position is not taken within a |

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| | | | reasonable time |
| Costs | Inordinate delays in ordering taking over of possession by Magistrate | Increase in administration and management costs of Magistrate | Increase in administration and management costs of Magistrate<br>Possibility of increase in matters filed at RTs, thereby increasing the burden at RTs |
| Benefits | Low administrative cost | Reduction in delays to order taking over of possession by Magistrate | Reduction in delays to order taking over of possession by Magistrate |

*3.1.1. Recommendation*

The comparison of impact of alternative 1 and 2 would reveal that net benefits under the former are expected to surpass those under the latter. This is because alternative 2 is expected to impose additional burden on RTs as well, and further delay debt recovery. Consequently, adoption of alternative 1 is recommended. This would require amendment in Section 14 of the SARFAESI Act.

### *3.2. Challenge of measures taken under SARFAESI Act*

Table 7.7 compares the baseline scenario with respect to challenge of measures taken under SARFAESI Act and the suggested alternatives

**Table 7.7: Challenge of Measures Taken under SARFAESI Act**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | Wide scope to challenge measures taken under SARFAESI Act, at DRTs | Statutory pre-requisite of establishing *locus standi* for challenge of action | Statutory penalties in case of unjustifiable challenge |
| Costs | Impediment to recovery resulting in delays | Increased cost of litigation for applicants challenging action under SARFAESI Act | Increase in litigation cost to fraudulent litigants<br>Salary cost: ₹2.64 crore (annual) |
| Benefits | Protection of interests of parties affected by measures taken under SARFAESI Act | Increase in summary disposal of fraudulent claims and reduced impediments to debt recovery | Reduction in the practice of filing of fraudulent claims, consequent improvement in recovery rate<br>Additional revenue generation for RTs |

*3.2.1. Recommendation*
Comparison of impact of alternatives 1 and 2 reveals that net benefits under alternative 2 are expected to surpass those under alternative 1. Alternative 2 is expected to adversely impact fraudulent litigants directly, and reduce the practice of filing of fraudulent applications at the RTs. Consequently, adoption of alternative 2 is recommended. This would require amendment in Section 17 of the SARFAESI Act.

### *3.3. Taking over of management by secured creditors/securitisation/reconstruction agencies*

Table 7.8 compares the baseline scenario with respect to taking over of management under the SARFAESI Act and suggested alternatives.

**Table 7.8: Taking over of Management under SARFAESI Act**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | Statutory requirement to restore management of business to borrower upon realisation of debt | Statutory provision of additional management fee for the secured creditor, who could stay in control of possession of secured asset, up to the recovery of management fee, in addition to debt | Amendment to scope of debt to include priority to recover cost of turnaround of borrower's management |
| Costs | Cost to secured creditor in turning around borrower's business without commensurate compensation, resulting in limited take up of this measure | Increase in cost to borrower in terms of greater fund outflow and delayed repossession of secured asset | Increase in cost to borrower in terms of greater fund outflow and delayed repossession of secured asset |
| Benefits | No need for the borrower to file for bankruptcy, and it remains afloat | Greater motivation to secured creditors to use this measure and consequent increase in debt recovery | Greater motivation to secured creditors to use this measure and consequent increase in debt recovery |

*3.3.1. Recommendation*
A comparison of alternatives 1 and 2 reveal that the net benefits under alternative 1 are expected to surpass those under alternative 2. This is because while alternative 2 mandatorily increases the time of possession of secured asset with the secured creditor, same is not the case under alternative 1. As a result, adoption of alternative 1 is recommended. This would require amendment to Section 13 of the SARFAESI Act.

### *3.4. Determination of correct valuation of secured asset*

Table 7.9 compares the baseline scenario with respect to provisions to determine correct valuation of secured asset under the SARFAESI Act and suggested alternatives.

**Table 7.9: Determination of Correct Valuation of Secured Asset under SARFAESI Act**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | No provision directing determination of correct valuation of secured asset<br>Prohibition to transfer secured assets amongst securitisation/ reconstruction companies | Removal on prohibition of transfer of secured assets amongst securitisation/ reconstruction companies, and public disclosure of valuation methodology | Insertion of general principles in SARFAESI Act regarding transparency and arm-length principle during valuation of secured asset |
| Costs | Transfer of secured asset often not at the market rate, hurting interests of secured creditors – resulting in limited use of this measure | Increase in cost of securitisation/ reconstruction process to securitisation/ reconstruction agencies | Increase in cost of securitisation/ reconstruction process to securitisation/ reconstruction agencies |
| Benefits | Prevention of circular and fraudulent trading amongst securitisation/ reconstruction companies<br>Low cost of securitisation/ reconstruction process to the securitisation/ reconstruction agencies | Significant possibility of ascertainment of correct valuation resulting in increased returns for secured creditors – resulting in greater uptake of this measure<br>Development of market for security interests | Reasonable possibility of ascertainment of correct valuation resulting in increased returns for secured creditors – resulting in greater uptake of this measure |

*3.4.1. Recommendation*

A comparison of alternatives under Table 7.9 reveals that net benefits of alternative 1 are expected to surpass those under alternative 2. Alternative 1 is also expected to result in deepening the market of non-performing loans and emergence of specialised entities. Consequently, adoption of alternative 1 is recommended. This would require amendment to Section 5 of the SARFAESI Act and consequent rules made thereunder.

### *3.5. Registration of security interest*

**Table 7.10** compares the baseline scenario with respect to registration of security interest under the SARFAESI Act and suggested alternatives.

**Table 7.10: Registration of Security Interest**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | Requirement on securitisation/ reconstruction companies of compulsory registration of creation, transfer, satisfaction of security interest, with the Central Registry | According priority to security interest from the date of registration | Making penalties proportional to the amount of security interest |
| Costs | High penalties on failure to register within the prescribed time period<br>No priority of charge from the date of registration | Minimal increase in cost to securitisation/ reconstruction companies<br>Reasonable increase in costs of Central Registry to manage increased flow of registration applications | Increase in cost of delay of parties to high value transactions |
| Benefits | Facility of search and ascertainment of security interests | Clarity in priority of security interests improving possibility of recovery<br>Greater usage of Central Registry | Reduction in cost of delay of parties to small value transactions<br>Greater focus of Central Registry |

*3.5.1. Recommendation*

A comparison of different alternatives discussed under Table 7.10 reveals that net benefits of alternative 1 would surpass those under alternative 2. Consequently, adoption of alternative 1 is recommended. This would require amendment to Chapter IV of the Securitisation Act and the related rules made thereunder.

## 4. Common Issues

### *4.1. Time limits for disposal of matters*

Table 7.11 compares the baseline scenario with respect to time limits for disposal of matters and the suggested alternatives.

**Table 7.11: Time Limits for Disposal of Matters**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | Recommendatory time limit for disposal | Provision for mandatory time limit with reimbursement of application fee on non-compliance | Periodic public disclosure of non-compliance with time lines and reasons thereof |
| Costs | Low compliance with the statutory time period, high opportunity | Reimbursement cost to RTs/ government: ₹24 crore (annual) | Salary cost: ₹2.64 crore (annual)<br>Additional information, |

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| | and litigation costs | Reduction in performance quality | communication and technology cost |
| Benefits | Low administration cost | Reimbursement benefit to litigants:₹24 crore (annual)<br>Opportunity cost saved: ₹3 crore (annual)<br>Improvement in disposal rate | Greater public scrutiny of RT performance, reduction in pendency and increase in disposal rate |

*4.1.1. Recommendation*

A comparison of alternative under Table 7.11 reveals that the net benefits under alternative 1 are expected to surpass those under alternative 2. The possibility of reimbursement of application fee will push the government to take measures for improvement of performance of RTs. Consequently, adoption of alternative 1 is recommended. This would require amendments to Sections 19 and 20 of the DRT Act and Section 17 of the SARFAESI Act.

***4.2. Exercise of jurisdiction by other courts/judicial authorities***

Table 7.12 compares the baseline scenario with respect to exercise of jurisdiction by other courts/judicial authorities and the suggested alternatives.

**Table 7.12: Exercise of Jurisdiction by Other Courts/Judicial Authorities**

| Particulars | Baseline | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Description | Unrestricted exercise of jurisdiction by other courts/judicial authorities despite contrary provisions | Public disclosure of matters pending on account of orders of other courts/judicial authorities, amount involved | Penalising the party approaching other courts/ judicial authorities |
| Costs | Low compliance with the statutory time period, high opportunity and litigation costs | Salary cost:₹2.64 crore (annual)<br>Additional information, communication and technology cost | Penalty on parties approaching other judicial authorities: ₹10 crore |
| Benefits | Low administration cost | Greater public scrutiny resulting in reduction of injunction orders by other courts/judicial authorities | Reduction in the practice of approaching other judicial authorities, consequent improvement in disposal rate |

*4.2.1. Recommendation*

A comparison of alternatives under Table 7.12 reveals that the net benefits under alternative 2 are expected to surpass those under alternative 1, and ensure greater compliance of the relevant statutes. Consequently, adoption of alternative 2 is recommended. This would require amendments to Section 18 of the DRT Act and Section 34 of the SARFAESI Act.

## 5. Other Recommendations

### *5.1. Priority of claims*

As discussed in previous chapters, lack of priority of creditors' claims over other dues, such as statutory and workmen dues, often act as a deterrent for debt recovery. It is thus suggested that secured creditors' claims are accorded priority to all the claims (including statutory claims) created subsequent to such secured creditors' claims. This would require an enabling amendment to the DRT Act and the SARFAESI Act. Similar suggestions have been made by experts[264] and the stakeholders during consultation under the project.

### *5.2. Clarificatory amendments to DRT Act and SARFAESI Act*

There are various provisions under the DRT Act and the SARFAESI Act, which have been intensely litigated and the position seems to be settled, for the time being by the Supreme Court. These include possibility of simultaneous proceedings under DRT Act and SARFAESI Act, definition of agriculture land, etc. However, possibility of confusion and misinterpretation in the future cannot be disregarded. Multiple protracted litigations, on account of lack of statutory clarity have imposed significant burden on the stakeholders and the judicial machinery. Consequently, it is suggested that settled interpretation be reinforced by making relevant amendments to the DRT Act. This would prevent future disputes and avoid unnecessary litigation cost.

### *5.3. Periodic training and capacity building*

One of the findings of the project was limited knowledge and capacity constraints of staff of the RTs. While the government has promised on various occasions to conduct periodic training and capacity building, this seems not to happen.[265]

Accordingly, it is suggested that a statutory provision be made in the DRT Act requiring government to ensure that the staff of the RTs have adequate knowledge and remain technically equipped to efficiently conduct their respective functions. The training could be provided by independent experts and practitioners in the sector. This is expected to result in incurrence of reasonable training costs, however, the benefits of training are expected to surpass the costs.[266] This would require insertion of an enabling provision in the DRT Act.

### *5.4. Periodic impact assessment*

As highlighted under the project, absence of periodic assessment of effectiveness of provisions of DRT Act and SARFAESI Act has resulted in inadequate implementation and sub-optimal results, such as the efficiency of securitisation and reconstruction process. The impact needs to be assessed on all the stakeholders, such as government, financial institutions, judiciary[267] *et al*.

[264] FSLRC Working Group on Banking (2013).
[265] The Raghuram Rajan Committee Report (2009) also noted the lack of judicial training for recovery officers.
[266] R Gandhi, Banks Recovery and Regulations: A synergy, Workshop for Judges of DRATs and Presiding Officers of DRTs, 29 December 2014, observes, "*The officials of DRTs / DRATs should be given proper training so that they appreciate the very purpose and adjudicate the cases in a way to meet the purpose for which these Tribunals are established*".
[267] Also known as Judicial Impact Assessment.

Consequently, periodic ex-post review of its provisions is necessary to ensure relevance of provisions, which keep track with changing realities. An enabling provision to this effect would be required in the DRT Act and SARFAESI Act. In addition, specific provisions must be inserted in the DRT Act and SARFAESI Act requiring RBI to justify any regulatory interventions it intends to make the expected costs and benefits and objectives of the proposed interventions. This would also require amendments to Sections 12 and 31A of the SARFAESI Act.

# Chapter 8
# Conclusion and Way Forward

## 1. Background

This study undertook an exercise of conducting regulatory impact assessment of primary legislations in the financial sector (banking) specifically focusing on debt recovery laws in India. Not surprisingly, the report emerges with quite interesting findings.

Addressing the issues highlighted in the study and subsequently accepting recommendations mentioned therein could substantially reduce the costs imposed on multiple stakeholders. For this reason, this chapter discusses conclusions and way forward of the study, summarising the net costs and benefits of the alternatives, and lessons learnt while undertaking the RIA exercise.

## 2. High Cost of Inefficient Regulation

As discussed in the earlier chapters, the objective of debt recovery laws is to ensure speedy recovery of debts due to banks and financial institutions. Literature on regulatory governance suggests that agencies must have adequate tools to be able to achieve the prescribed objectives.[268] The tools/agencies provided by DRT Act and SARFAESI Act are in the form of special purpose recovery tribunals (DRTs and DRATs), and special purpose vehicles in form of RCs and SCs to ensure fast and efficient debt recovery.

Analysis of regulatory governance has shown that availability of adequate tools and independence is necessary, but not an adequate condition, to ensure effective implementation of legislations. Government agencies must have the capacity and independence to use the appropriate tools, and the misuse of independence/discretion must be checked by putting in place adequate transparency and accountability mechanisms.

The study reveals that on this account the process of drafting legislations in India seems to be failing. Inadequate capacity and accountability mechanisms have led to delays in decision making and consequent recovery of due amounts. The study has estimated an opportunity cost of around ₹35,000 crore owing to delay in debt recovery (of up to four years) on a consolidated basis (DRT Act and SARFAESI Act).

Low debt recovery has also resulted in credit risk premium of around 300 basis points, resulting in high cost of funds. In addition, opportunity cost of litigation for fiscal 2013-14 has been estimated around ₹2,000 crore.

Moreover, the social cost of the amount of loans written off by commercial banks in past five years (i.e., ₹1,61,018 crore, equivalent to 1.27 percent of GDP) would have allowed 1.5mn of

[268] Report of the Financial Sector Legislative Reforms Commission, available at: http://finmin.nic.in/fslrc/fslrc_index.asp

the poorest children to get a full university degree from top private universities of the country[269].

## 3. Post Study Developments

The study takes into account developments up to first half of 2015, situation has not improved since.[270] The government and RBI appear to be occupied with minor short-term fixes,[271] but a comprehensive strategy to manage high non-performing assets, improve debt recovery, and prevent recurring of this episode in future seems to be missing.[272]

The government is also in the process of reforming the bankruptcy regime in the country. The T K Vishwanathan expert committee has drafted a Draft Insolvency Bill in this regard, which confers jurisdiction on RTs for matters related to insolvency resolution and bankruptcy for individuals and partnership firms.[273] However, the situation of RTs in the country remains deplorable, and they are facing severe capacity constraints.[274]

Consequently, urgent measures are needed to improve the debt recovery situation, reduce costs imposed on stakeholders on account of inefficient regulatory regime, and put in place efficient regulatory governance in banking sector in India.

Table 8.1 provides a snapshot of the recommendations made under the project.

**Table 8.1: Key Recommendations under the Project**

| **DRT Act** |
|---|
| Revise upwards the threshold for filing applications to ₹25,00,000 and minimum application fee to ₹30,000 |
| Establishment of 24 new DRTs |
| Provision of technical members at RTs |
| Constitution of independent advisory body to recommend candidates to fill vacancies of RTs |
| Additional cost for grant of adjournment at increasing rate (0.1 percent of matter) beyond reasonable number |
| **Securitisation Act** |

[269] Raghuram Rajan, Third Dr Verghese Kurien Memorial Lecture, available at: *https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=929*

[270] *NPA problem to continue for next 2-3 quarters: PSBs to FinMin*, Moneycontrol, October 22, 2015, available at: *http://www.moneycontrol.com/news/economy/npa-problem-to-cont-for-next-2-3-quarters-psbs-to-finmin_3726261.html*. Vishwanathan Nair, *Pending cases pile up at debt recovery tribunals,* Livemint, August 28, 2015, notes, '*assuming no further build-up of cases, it would take DRTs more than five years to clear current backlog*'.

[271] Jaideep Deogharia, *RBI asks banks to improve NPA management*, 09 November 2015, available at: *http://timesofindia.indiatimes.com/city/ranchi/RBI-asks-banks-to-improve-NPA-management/articleshow/49729403.cms*, last visited on October 18, 2015.

[272] Radhika Mervin, *India Inc caught in a debt trap,* November 15, 2015, available at: *http://www.thehindubusinessline.com/portfolio/india-inc-caught-in-a-debt-trap/article7880729.ece*, last visited on October 18, 2015.

[273] The draft Insolvency and Bankruptcy Bill 2015 is available at: *http://www.finmin.nic.in/reports/DraftInsolvencyBankruptcyBil2015.pdf*

[274] Mustafa Plumber, Provide space to debt recovery bodies in South Mumbai: Bombay High Court to port trust, DNA, November 06, 2015, available at: *http://www.dnaindia.com/mumbai/report-provide-space-to-debt-recovery-bodies-in-south-mumbai-bombay-high-court-to-port-trust-2142507*, last visited on November 18, 2015

| |
|---|
| Specific time period within which the Magistrate will be required to take possession |
| Statutory penalties in case of unjustifiable challenge of action under Securitisation Act |
| Statutory provision of additional management fee for the secured creditor, who could stay in control of possession of secured asset, up to recovery of management fee, in addition to debt |
| Removal on prohibition on transfer of secured assets amongst securitisation/ reconstruction companies, and public disclosure of valuation methodology |
| According priority to security interest from the date of registration |
| **Common issues** |
| Provision for mandatory time limit for disposal of matters with reimbursement of application fee on non-compliance |
| Penalising the party approaching other courts/ judicial authorities |

The initial cumulative cost of all the recommendations put together is estimated to be around ₹100 crore, in addition to indirect, infrastructure, management, administration, training and capacity building costs on stakeholders including litigants, government, RTs, securitisation and reconstruction companies, and other indirect costs to market, consumers, and society at large. However, such costs are expected to be greatly outweighed by expected benefits, i.e. substantial reduction in delays and significant improvement in debt recovery process under the DRT Act and SARFAESI Act.

## 4. Way Forward

Several stakeholders have endorsed recommendations made under the project,[275] and the government is also looking to reform and improve the debt recovery process. [276] However, the government must learn from it mistakes, plan efficiently about the transition process, involve stakeholders in developing such plan, which takes into account implementation challenges, and set targets and accountability standards.

RIA can play an important role in this regard. It formalises stakeholder consultation, ensures transparency, enables adoption of most efficient regulatory alternatives keeping in mind ground realities, and aids in fixing accountability.

In addition, the government must avoid thinking in silos, and learn from best practices elsewhere. While it has taken commendable steps to reform the insolvency regime, the measures taken to improve management of banks have been inadequate, despite several

[275] M V Kini, *Huge build up of NPAs: Why debt recovery tribunals are in no shape to perform*, 30 August 2015, available at: http://articles.economictimes.indiatimes.com/2015-08-30/news/66032920_1_debt-recovery-tribunals-drts-bank-gross-npas suggests, "*There are ways of expanding the DRT system quickly. DRT judges should be chosen from amongst young bank officers, say, holding a position of DGM rank with a law degree. On completion of their term, they should be elevated on priority in banks. The second issue is that of lack of infrastructure such as premises, stenographers, administrative staff, computers and the like. This can be easily solved if each bank provides an area of 5,000 to 10,000 sq. ft from their buildings*".

[276] Dheeraj Tiwari, *Finance Ministry seeks to make debt recovery tribnals accountable*, 04 September 2015, The Economic Times, available at: http://economictimes.indiatimes.com/news/economy/policy/finance-ministry-seeks-to-make-debt-recovery-tribunals-more-accountable/articleshow/48863155.cms, last visited on 18 November 2015, and *Government plans to overhaul debt recovery tribunals: Jaitely*, September 29, 2015, The Financial Express, available at: http://www.financialexpress.com/article/industry/banking-finance/overhaul-of-debt-recovery-tribunals-on-cards-arun-jaitley/142809/, last visited on November 18, 2015.

government appointed expert committees[277] mooting for the same. It has shown intentions to reform debt recovery but the steps taken in this regard have been negligent. It should be understood that all such reform proposals are inter-related and will work as a package, to achieve maximum benefits. Debt recovery cannot be improved without insolvency and management reforms, and vice versa.

To ensure a broader reform agenda, institutionalisation of a Regulatory Reform Cell is necessary. Such cell must have a better regulation agenda of which RIA should be an integral part. Such cell must be equipped with conducting periodic review of regulations and ensure that regulatory objectives are met.

## 5. Checks and Balances while Conducting RIA

Besides providing relevant recommendations to ensure achievement of objectives of legislations in financial sector, this study offers important lessons for undertaking RIA. Some such critical lessons are listed below:

- Correct identification of the problem, which needs to be addressed, is a necessary starting point for conducting RIA. Equally significant is to select the legislations on which RIA needs to be conducted.
- Data collection and analysis, understandably, are most critical aspects of RIA. Stakeholders would need to be convinced about confidentiality of data, and benefits they could expect from the RIA exercise, should they be required to part with relevant data and information, necessary to conduct RIA.
- Interactions/consultations with different stakeholder categories, and keeping a healthy stakeholder mix, is absolutely essential, to comprehensively capture concerns of different stakeholders, ensure unbiased and impartial assessment, and prevent regulatory capture.[278]
- While recommending cost effective alternatives is necessary, ensuring that benefits of the alternatives are expected to, and in practice, outweigh the costs in much more important, for sustainable improvement in regulatory governance.
- There is no one-size-fits all RIA model and the RIA process has to be customised on the basis of ground realities, and availability of information. In addition, one must realise that RIA is not a panacea to solve all the problems, and must be treated as a part of a comprehensive package of regulatory reforms.

To ensure uptake of RIA, political will is necessary. The policy makers must appreciate the benefits of RIA and actively work towards adopting the same. To enable institutionalisation of RIA, training and capacity building of relevant government institutions to undertake in-depth RIA would be required. Building such capacity and conducting periodic RIAs would put significant strain on exchequer. However, the consequent benefits of improved regulatory governance and imposition of minimal costs on stakeholders to achieve regulatory objectives are expected to outweigh the costs of institutionalisation and conducting RIA.

[277] Such as the P J Nayak Committee. The government has formulated Indradhanush plan, but the same is inadequate and does not takes into account significant recommendations of the Committee.
[278] David E M Sappington, *Principles of Regulatory Policy Design*, University of Florida, 1993.

# PART II

# Regulatory Impact Assessment in Indian Insurance Sector: Facilitating investments and enabling access

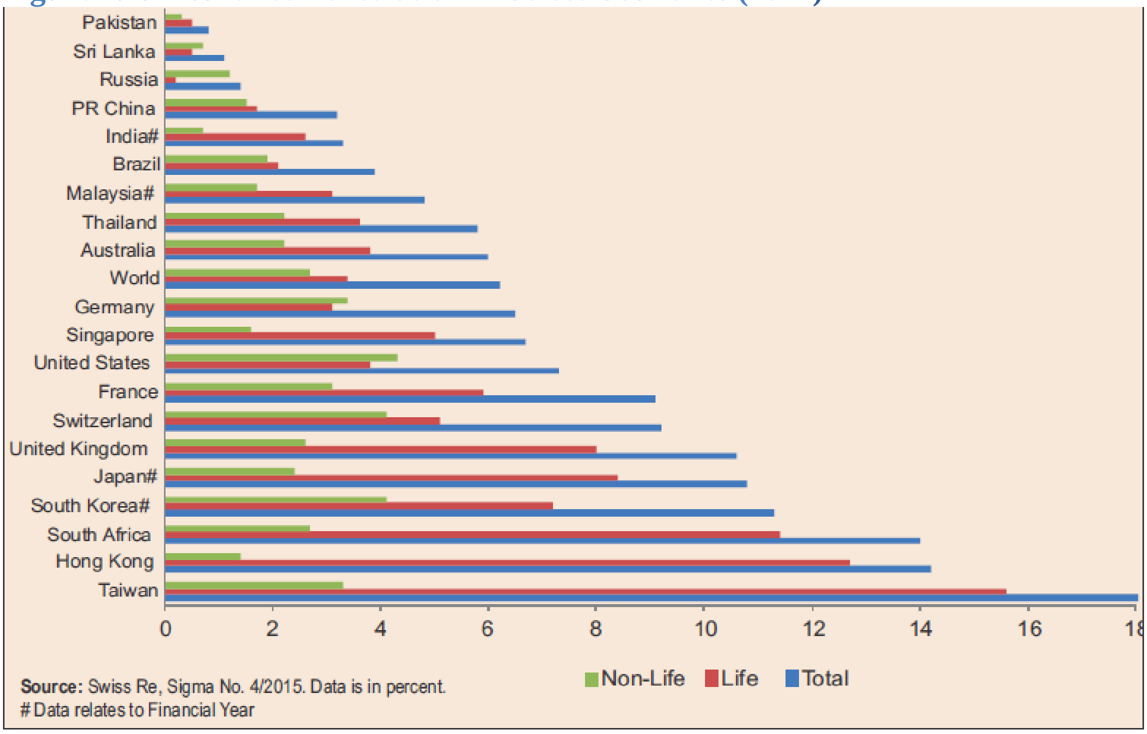
## CONTENTS

## Chapter 1
## State of Insurance Sector

Insurance is a public good and access to basic insurance services is necessary for dealing with contingencies and emergency situations. Insurance becomes much more essential in country like India with significant poor population, facing income and health uncertainties.

India currently accounts for less than 1.5 percent of the world's total insurance premiums and about 2 percent of the world's life insurance premiums despite being the second most populous nation.[279] Access to basic financial services is essential to enable poor deal with uncertainties and contingencies. The insurance sector is very similar to the banking sector in that both are vehicles and instrumentalities for encouraging savings amongst the people in the country.

**Figure 1.1: Insurance Penetration in Select Countries (2014)[280]**

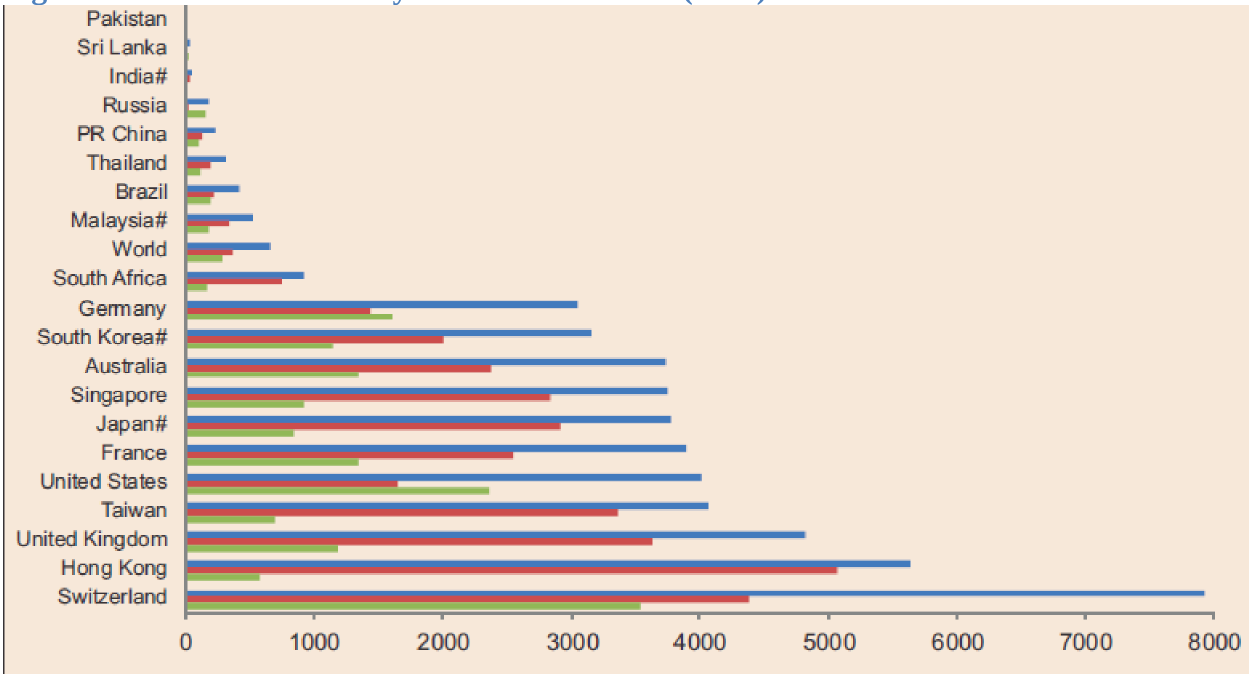



Access to insurance is measured by indicators like insurance penetration and insurance density. Insurance penetration is the ratio of premium collected in a given year to the gross domestic product (GDP) and density is ratio of premium collected in a given year to the total population. The measure of insurance penetration and density reflects the level of development of insurance sector in a country. India is witnessing a consistent drop in insurance penetration and density. During the first decade of insurance sector liberalisation, the sector has reported consistent increase in insurance penetration from 2.71 per cent in 2001 to 5.20 percent in 2009. However, since then, the level of penetration has been declining reaching 3.3 percent in 2014. This has been the lowest since 2005-06, when the penetration

[279] India Brand Equity Foundation, *Insurance Sector in India*, December 2015, http://www.ibef.org/industry/insurance-sector-india.aspx, accessed on 19 January 2016
[280] Figure taken from IRDA Annual Report 2014-15

was at 3.14 percent. Globally, the average insurance penetration stands at 6.2 percent. A similar trend was observed in the level of insurance density which reached the maximum of USD 64.4 in the year 2010 from the level of USD 11.5 in 2001. During 2014, the insurance density was USD 55.0. Without adequate insurance penetration and density, the poor would remain excluded from the benefits of formal financial system and depend on costly informal sources to deal with uncertainties, thus remaining trapped in the vicious cycle of poverty.

**Figure 1.2: Insurance Density in Select Countries (2014)**




**Source:** Swiss Re, Sigma No. 4/2015. Data is in USD
# data relates to financial year

## Deprivation from life insurance

India's share in global life insurance market was merely 2.08 percent during 2014. The life insurance premium in India increased only by 1.0 percent (inflation adjusted) when global life insurance premium increased by 4.3 percent.[281] While the insurance density of life insurance business had gone up from USD 9.1 in 2001 to reach the peak at USD 55.7 in 2010, it declined to a mere USD 44 by 2014. The global life insurance density is around USD 400 and countries such as Switzerland and Japan recorded a life insurance density of more than USD 4,000 in recent years.

Similarly, the life insurance penetration in the country had surged from 2.15 percent in 2001 to 4.60 percent in 2009. Since then, it has exhibited a declining trend reaching 2.6 percent in 2014.[282] Countries such as Taiwan, South Africa and Japan have consistently recorded a life insurance penetration of more than 10 percent.[283] During 2014-15, the life insurance industry

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[281] IDRA Annual Report 2014-15, January 2016
[282] M. Saraswathy, *Insurance penetration at 10-year low*, Business Standard, 25 June 2015 , and IDRA Annual Report 2014-15, January 2016
[283]Pradeep S Mehta (ed.), *Competition, Regulation and Consumer Protection in Indian Financial Sector*, State of Competition and Regulation in India, CUTS International, 2013

witnessed a 36.61 percent decline (7.50 percent decline in 2013-14), in the number of new policies issued.[284]

Given the importance of life insurance in one's life, and performance of this segment in the country, greater push is required to increase penetration and density of life insurance. The insurance industry of India consists of 53 insurance companies of which 24 are in life insurance business and 28 are non-life insurers.[285] During the decade from fiscal 2004 to fiscal 2014, the life insurance premium market in India expanded at a Compounded Annual Growth Rate (CAGR) of 15.3 percent, from USD 14.5 billion in FY04 to USD 60.3 billion in FY14. The non-life insurance premium market rose at a CAGR of 16.3 percent, from USD 3.4 billion in FY04 to USD11.7 billion in FY14.[286] However, this growth rate fades on comparison with peers. The total real premium growth rate in 2013 in emerging economies was 7.4 percent but India recorded a negative growth of -0.4 percent. In life insurance segment the emerging market growth rate was 6.4 percent, whereas India recorded a negative growth of -1.1 percent.[287] As a result, access to insurance, and specifically life insurance, is still a luxury to many in the country. The need to increase insurance penetration is often discussed in the Parliament, with a suggestion to introduce regulatory and taxation reforms with this objective.[288]

## Reasons for insufficient access

Majumdar (2015) suggests that insurance penetration has remained low in rural and informal sectors of the country on account of several reasons, including: low quality/ skill of agents in rural areas; inadequate use of alternate channels of distribution (such as banks) by insurers in rural areas; lack of customised products for rural and informal sector; sub-optimal marketing of low cost group insurance products, etc. It has been suggested that agents need to be better trained and properly motivated to tap rural and informal market; banks need to increase their involvement in rural and informal sector; and customised products needs to be designed for increasing insurance reach to rural areas.[289]

Problems like poor infrastructure in rural areas, high agent procurement cost, need of significant efforts to gain trust and confidence of rural inhabitants, low awareness level, need to travel long distances, high illiteracy levels, high cost of operations, etc. have been repeatedly identified as a reason for low insurance penetration and density.[290]

A recent joint study by CRISIL and ASSOCHAM noted that insurance has been hitherto largely sold as a tax-saving instrument rather than as a safety cushion for contingencies.

[284] IDRA Annual Report 2014-15, January 2016
[285] IRDAI, *Insurance market,* IRDAI Consumer Education Website, http://www.policyholder.gov.in/indian_insurance_market.aspx, accessed on 09 January 2016
[286] India Brand Equity Foundation, *Insurance,* August 2015
[287] Swiss Re, Sigma 3/2014, as cited in IRDA Annual Report 2013-14, January 2015
[288] Rajya Sabha unstarred question no 2230, answered on 13 December 2012, as "*consultations have been held with the insurance industry and steps have been identified for action, to give fillip to the sector and expand insurance penetration. These include regulatory issues as well as tax related measures including direct tax and service tax benefits*."
[289] Nirjhar Majumdar, *There is a business opportunity at the bottom of the pyramid,* IRDAI Journal: Next Stop for Insurance – Rural Insurance, June 2015
[290] R. Venugopal, *Reaping the rural revolution,* IRDAI Journal: Next Stop for Insurance – Rural Insurance, June 2015

There is a considerable amount of misinformation about insurance in the mind of the average Indian investor and hence a crying need to change people's perception and outlook on insurance. It stressed that in order to increase insurance penetration, steps required include, making premium more affordable; creating insurance awareness; simplifying products for the masses; designing tailor-made products for different target audience.[291] The study highlights that the key to enhancing insurance penetration is investing in distribution.

*Problems in expanding reach of life insurance*

A 2013 study by Insurance Information Bureau highlighted that more than 55 crore people in the country have very limited access to life insurance. The bottom 120 districts in terms of life insurance penetration had an average agency penetration[292] of 0.77 during 2012-13, compared with an all-India average of 3.15, and the agency penetration in top 50 districts being more than 7. The report highlights the causes for low agency penetration, and consequently, low life insurance penetration and density amongst low income segments as, *inter alia*, low appetite for insurance; non availability of qualified agents in these locations; low ticket sizes; high cost of operation and viability for life insurers.[293] Other challenges that life insurers face, as highlighted by Hegde (2015), include the geographical spread of rural branches across the length and breadth of the country making it difficult to ensure the presence of a life insurance expert at these branches; non-availability of technology backbone similar to what is available in urban branches; and high cost of doing business in these locations vis-à-vis the business generated.[294]

The inability of insurance industry to expand its reach has been exacerbated by high agent attrition rate. Reports suggest that 24 life insurers collectively lost nearly nine lakh agents in just five years to other sectors[295], and the Life Insurance Council suggests that there was a decline of more than 24,000 in the agency force in the first nine months of fiscal 2016.[296] The Insurance Information Bureau estimated that increase in number of agency licenses by close to 2,00,000 licenses in under exploited states in the country has the potential to generate additional new business premium of more than Rs. 3,000 crore.[297] However, increasing agency network is expected to require significant investments in recruitment, training and retaining agents.

While insurance industry as a whole is facing problems to increase access, life insurance segment in particular is grappling with severe constraints. These limitations need to be urgently addressed to increase the life insurance penetration and density in India.

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[291] ASSOCHAM India and CRISIL Research, *Inclusion + Intermediation + Technology = Inflection, The next game in Insurance*, October 2015

[292] The report defined agency penetration as the number of valid life insurance agency licenses per thousand population.

[293] Insurance Information Bureau, *Spread of life insurance agents across locations in India*', November 2013

[294] Ashay Ravi Hegde, *Increasing insurance penetration to rural and informal sector of the economy,* IRDAI Journal: Next Stop for Insurance – Rural Insurance, June 2015

[295] *Policy of Quitting Claims 9 Lakh Insurance Agents in Five Years*, The New Indian Express, 15 December 2015. It notes, "Youngsters do not want to become insurance agents. Selling insurance is a tough job — the youth find it difficult to understand and communicate. Despite training, we are unable to retain them," V Manickam, Secretary, Life Insurance Council told Express. Insurers have been losing about 30,000-40,000 agents every month and the number now stands at 20,37,007 agents as on November, 2015 down from 28,98,653 in FY10. "These 20 lakh agents reached out to just 25 crore people and still 75 crore are yet to be addressed," Manickam said."

[296] Deepa Nair, *Agent attrition continues to haunt life insurers,* The Hindu Business Line, 18 January 2016

[297] Insurance Information Bureau, *Spread of life insurance agents across locations in India*', November 2013

## Need to increase investments

The level of insurance access depends on a large number of factors like level of economic development of the economy, the extent of the savings in financial instruments and the size and reach of the insurance sector.[298] Insurance penetration and density cannot increase without more investments,[299] and significant increase in the number of investors and players going deeper into the countryside. Insurance has been a historically significant product for investors and its popularity is likely to grow exponentially as more investors realise its importance. Insurance penetration and investments in the sector are pro-cyclical in nature. This means that low penetration limits revenue generation and consequently the bottom line of insurers, thus attracting fewer investments. Inadequate investments in the sector limit the opportunity of insurers to expand the operations and increase penetration. There is an urgent requirement to break this cycle for industry to grow.

It has been expected that the insurance industry will require INR500 billion (US$7.5 billion) to INR600 billion (US$8.9 billion) in capital to improve insurance penetration in the country from around 3 percent of gross domestic product at present to 6 percent, the world average.[300] Investments will be required for increasing last mile access, creating effective agency structures, identification of alternative network channels, etc.[301] According to Swiss Re (2015), technology and the digital data revolution is expected fundamentally change the business of insurance. To grow their business, insurers will need to review their investments in technology, rethink talent strategy and adapt their business models.[302] Consequently, the industry needs to invest in innovation and technology to come up with low cost products, automate various processes and cut costs without affecting service delivery.[303]

*Investments required in life insurance*

Life insurance industry is capital intensive, and insurers are required to infuse capital at regular intervals to fund both the new business strain and to expand their infrastructure base including expenses on initial operations, training costs for development of the distribution channels, creating niche markets and achieving reasonable levels of persistency. The experience of the insurance markets globally indicates that companies in the life sector take seven to ten years to break-even.[304] Many private players in the life insurance sector have incurred losses due to lack of scale and the long term and capital intensive nature of business.

[298] Rajya Sabha unstarred question no 1375, answered on 10 March 2015
[299] PTI, *FDI hike in insurance will help deepen penetration: Vijayan*, 10 December 2015
[300] Asia Insurance Review, *India: Insurers need USD 9 billion to reach global average penetration*, 16 December 2015. In March 2015, Minister of State for Finance Jayant Sinha said: "What we estimated is, if we have to increase insurance penetration from 3 percent currently to 6 percent, then we will require capital somewhere in the range of INR400-500 billion, of which of course 49 percent will have to come from FDI. "So we are talking about (foreign) investment in the range of INR250 billion in the insurance sector to really ensure that we get to 6% penetration in the medium term."
[301] K. Kumar, *Need for increasing insurance penetration in India*, Bimabazaar, March 2014
[302] Swiss Re, Life insurance in the digital age: fundamental transformation ahead, Sigma No 6/2015. It notes, "*While new technology presents opportunities, but also gives rise to new challenges that life insurers need to address. One is regulation, with lack of clarity and consistency around data protection and privacy.*"
[303] India Brand Equity Foundation, *Insurance,* August 2015
[304] IRDA Annual Report 2013-14, January 2015

Moderate- to-heavy losses and slow premium growth have led several foreign joint ventures to exit the Indian life insurance market.[305] Consequently, there is a need to review investment scenario in life insurance sector, and address prevailing challenges.

*Potential to increase returns for industry*

Improvement in insurance access is not merely important from society's point of view, but is also significant for industry's growth. As per the existing growth rate of the industry, the premium collected and the commissions in the life insurance is expected to grow by Compound Annual Growth Rate (CAGR) of 15 percent each, by 2020 to Rs. 7.22 lakh crore ($115.44 bn) and Rs. 48,000 crores ($7,674 mn), respectively. The premium and commission under non-life segment are expected to grow by CAGR of 12 percent each- to Rs.0.98 lakh crore ($15.67 bn) and Rs.6,400 crores ($1,023 mn), respectively. However, with increase in investments and penetration, the premium collected and the commissions in the life insurance segment is expected to grow by CAGR of 19 percent each, by 2020 to Rs. 8.74 lakh crore ($139.74 bn) and Rs. 58,000 crores ($9,273 mn), respectively. The premium and commission under non-life segment is expected to grow by CAGR of 17 percent each to Rs.1.31 lakh crore ($20.94 bn) and Rs.8,500 crores ($1,359 mn), respectively.[306]

The country is fifteenth largest insurance market in the world in terms of premium volume, and has the potential to grow exponentially in the coming years. India's insurable population is anticipated to touch 750 million in 2020, with life expectancy reaching 74 years. Furthermore, life insurance is projected to comprise 35 percent of total savings by the end of this decade, as against 26 percent in 2009-10. Demographic factors such as growing middle class, young insurable population and growing awareness of the need for protection and retirement planning are expected to support the growth of Indian life insurance.[307] India's insurance market is expected to quadruple in size over the next 10 years from its current size of US$ 60 billion. During this period, the life insurance market is slated to cross US$ 160 billion. The general insurance business in India is currently at Rs 78,000 crore (US$ 11.7 billion) premium per annum industry and is growing at a healthy rate of 17 per cent.[308]

As per the FIAI-CRISIL report on India's financial distribution industry, assuming penetration levels remain the same as today, the insurance industry is estimated to log a none-too-inspiring growth rate. In case of life insurance, total premium is expected to increase from Rs 3.14 lakh to Rs 7.41 lakh crore by 2020, while in the non-life segment premiums could grow to around Rs 1.38 lakh crore from Rs 0.71 lakh crore. However, should penetration increase, as a result of increased investment, the total premium in the life insurance segment is estimated to nearly treble from Rs 3.14 lakh crore in 2014 to Rs. 8.98 lakh crore in 2020, even as the non-life insurance segment goes from Rs 0.71 lakh crore to Rs 1.83 lakh crore.[309] The large population in India that is currently underinsured or uninsured presents a huge opportunity for the life insurance industry. As more youngsters enter the workforce, there will be a burgeoning need for financial security and life insurance will play

[305] India Briefing, *Investing in India's Insurance Sector,* 16 June 2015, http://www.india-briefing.com/news/investing-indias-insurance-industry-10856.html/, accessed on 09 January 2016

[306] Financial Intermediaries Association of India and CRISIL Research, *Indian Financial Distribution Industry at the cusp: Vision 2020*, March 2015

[307] India Brand Equity Foundation, *Insurance sector in India,* December 2015, http://www.ibef.org/industry/insurance-sector-india.aspx, accessed on 09 January 2016

[308] India Brand Equity Foundation, *Insurance,* August 2015

[309] Financial Intermediaries Association of India and CRISIL Research, *Indian Financial Distribution Industry at the cusp: Vision 2020*, March 2015

a crucial role in providing this. Consequently, it is crucial for the industry to enhance penetration so as to be able to reach out to the farthest corner of the country.[310]

Increase in investment is also necessary to meet customer expectations. The World Insurance Report 2015 highlights that customer experience declined globally in 2014 indicating that insurers are not keeping pace with rising expectations. India was amongst the bottom 10 countries recording a drop of 7.6 percent in customer experience. The report notes that digital channels are dragging down customer experience levels around the world, and insurers of the future will need to fully blend agent-guided, high value engagements with digital transactions via mobile and social media, to meet customer expectations.[311]

[310] Jimmy John, *India: Life is Positive,* Asia Insurance Review, January 2016
[311] Capgemini and Efma, *World Insurance Report, 2015,* available at https://www.worldinsurancereport.com/

# Chapter 2
# Need for Regulatory Impact Assessment in Life Insurance Sector

Regulations affect behaviour of any stakeholder in any sector and unsurprisingly, they play a major role in investment related decisions in the life insurance sector. While an enabling and predictable regulatory regime provides confidence to investor to investment capital and skill in any sector, an uncertain regulatory and policy regime could force existing and potential investors to review their decisions and hold back further investments.

The World Investment Report (2015) notes the global foreign direct investment inflows fell by 16 percent in 2014 to USD 1.23 trillion, down from USD 1.47 trillion in 2013. This decline was influenced mainly by the fragility of the global economy, policy uncertainty for investors and elevated geopolitical risks. Handley and Limao (2012) provided evidence that policy uncertainty can significantly affect firm level investment and entry decisions in the context of international trade. Gulen and Ion (2013) discovered that policy-related uncertainty is negatively related to firm and industry level investment, and the economic magnitude of the effect is substantial. Anand and Tulin (2014) established that heightened uncertainty and deteriorating business confidence in India have played a key role in investment slowdown. Similarly, Bernanke (1983) pointed out that high uncertainty gives firms an incentive to delay investment and hiring, when investment projects are expensive to cancel or workers are costly to hire and fire. Dixit (1989) showed that uncertainty about future prices creates an option value of waiting, so firms will delay investments in entry or exit until they receive more information. Also, Dixit and Pindyck (1994) found that in the presence of uncertainty and given the irreversibility of investment decisions, investors may choose to forego or delay investment to avoid bearing the cost of investing in the wrong activity.[312]

Consequently, there is a need to review the regulatory scenario in insurance sector, in order to assess if it is restricting investments or is not providing appropriate incentives to promote investments.

Regulatory impact assessment is a globally recognised tool to assess impact of regulatory proposals by estimating costs and benefits of such regulations on different stakeholders, including economy, society and environment. It has been adopted by several advanced economies, including United States, United Kingdom and Australia. The US President recently issued an executive order directing use of behaviour science to design government policies. The order states, "*the Federal Government should design its policies and programs to reflect our best understanding of how people engage with, participate in, use, and respond to those policies and programs.*" The order was part of a series of orders issued from time to time to improve regulation and reduce regulatory burdens, using evidence based policy making.[313]

The EU also recently updated its better regulation toolbox, of which impact assessment is a salient feature. The Red Tape Challenge in UK has resulted in £300 million in annual savings to 100,000 small businesses from increased flexibility on audit requirements, and around £132 million estimated savings to business from cleaner guidance about contaminated land

[312] CUTS International et al, *Background note: Reducing Policy Uncertainty to Revive Investment*, October 2014, available at http://goo.gl/glS4PR
[313] US Executive Order, *Using Behavioral Science Insights to Better Serve the American People*, 15 September 2015, available at https://goo.gl/gQ5RMw

use. The One-In Two-Out rule in UK essentially requires estimation of burden of existing and proposed regulations to enable removal of £2 of existing regulatory burden, for introduction of every £1 of regulatory burden. RIA has been recommended for India by several expert committees like Financial Sector Legislative Reforms Committee, Damodaran Committee, and Tax Administration and Reforms Committee.

Consequently, in order to determine efficiency of prevailing regulations, and assessing if these are promoting or hindering investments, RIA in insurance sector would be necessary.

## Regulatory architecture in insurance sector

The regulatory architecture of insurance sector in the country is very wide and complex. The Insurance Act, 1938 is the principal legislation in the insurance sector. It was enacted to consolidate and amend the law relating to insurance in the sector. It requires insurers to obtain a certificate of registration from IRDA for carrying on insurance business, and insurance agents to obtain a license. It also sets out minimum limits of annuities and other benefits secured by policies of life insurance, capital requirements, voting rights in insurance companies etc. The Insurance Act also requires insurer to make specific investments, and specifies restrictions on granting loans on insurers. It empowers IRDA to restrict payment of excessive commission, conduct investigation and inspection, and change management. It also sets limitation of different expenses which could be made by insurers. The Insurance Act is perhaps the only primary law which has the foreign investment limit prescribed in the statute. At present, Indian owned and controlled insurance companies are permitted to have foreign investment up to 49 percent of their paid up share capital. This recent increase in the maximum allowable ownership of insurers from 26 percent to 49 percent is likely to stimulate additional investment in the market sector, which is in great need of capital and product and service innovation.[314] Such investments will take their own time, and can happen only when regulatory certainty and predictability is the order of the day.

The IRDA Act, 1999 was enacted to establish IRDA to protect the interests of holders of insurance policies, and to regulate, promote and ensure orderly growth of the insurance industry. It provides for composition and membership of IRDA, its duties, powers and functions, powers of central government to issue directions to IRDA etc. In addition, IRDA and Ministry of Finance issues several circulars, regulations, guidelines, press notes, rules etc to regulate the industry.

## Focus on life insurance

The regulatory instruments issued by different regulatory agencies cover diverse segments of the insurance industry, such as life, general, health, and reinsurance. They also cover insurance intermediaries like agents, brokers, surveyors, web aggregators, repositories and marketing firms.

However, as indicated earlier, life insurance is one of the most critical segments of insurance sector. Access to life insurance is extremely low in the country and the efforts to reach out to the masses have not resulted in desired results. Moreover, life insurance being capital intensive business, it has substantial investment requirements.

[314] E&Y, *2015 Global Insurance Outlook*

Limiting the scope of this report is also essential taking into account the time availability and capacity constraints. Consequently, this report conducts RIA in life insurance sector. This approach has been approved by the experts comprising national reference group for the project.

# Chapter 3
# Description of key regulations

The primary and secondary regulations in life insurance sector cover various aspects of this business. This include regulations on investors in insurance companies, investment which insurers are permitted to make, the extent of expenses and commissions allowed to be paid, design of non-linked and linked products etc. The regulations also cover registration requirements for brokers, agents and conditions for banks acting as agents, disclosure requirements in advertisements, grievance redress mechanisms etc. With the advent of Insurance (Amendment) Act, 2015, the regulator is reviewing many of these regulations, and has been putting revised drafts in public domain for consultation.[315]

In order to identify critical legislations that influence investment decisions in the insurance sector, primary and secondary research was conducted. This involved desk research and review of existing regulations in life insurance, identifying their relation with investments in the sector, identification of information gaps, developing of stakeholder interaction tools, discussion with stakeholders for plugging the information gaps and validating findings of secondary research, and finalisation of regulations for RIA.

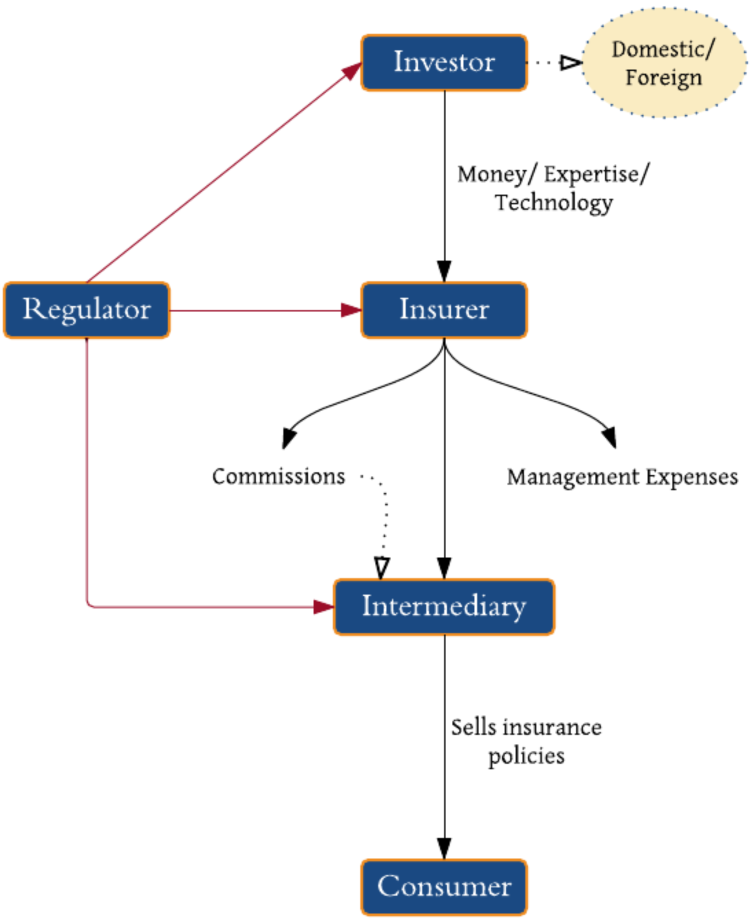
Key stakeholder categories in life insurance sector are investors, insurers, intermediaries and consumers. The sector regulator attempts to nudge behaviour of these stakeholders towards consumers' interests. Investments in the sector are guided by the burden that regulations impose on these stakeholders.

Initial literature review and stakeholder interaction revealed that regulations dictate behaviour of investors with the respect to the amount and the related rights which could accrue to investors. There are regulations around operating expenses of insurers, commissions of intermediaries, and the products which the insurers are supposed to push.

All this impacts the expenses of management and operating costs of insurers and their consequent need for investments. Regulations around remuneration and retention of consumers by intermediaries and insurers guide the interaction between insurers/ intermediaries and consumers. Treatment of consumers by market players impacts revenues for insurers and consequently determines attractiveness of insurers for investors.

[315] Exposure drafts issued by IRDA are available at https://goo.gl/xSJeud

**Figure 3. 1 - Relationship between different stakeholders in the insurance sector**




In light of above, regulations governing following areas in life insurance sector were selected to conduct RIA:

1. Investment in insurance companies
2. Expenditure by insurance companies
3. Retention of consumers

Consequently, this study attempts to study regulations, which directly influence investors, insurers and intermediaries, without losing sight of consumers' interest and regulator's role in the sector.

## Regulation of investment in insurance companies

A private insurance company can raise capital from domestic as well as foreign sources, and there are regulations on both.

*Foreign investment:*

The Insurance Act, 1938, is perhaps the only national legislation in which the foreign investment cap features.[316] At present, foreign investment is permitted up to 49 percent of paid up equity capital of Indian insurance companies[317], which are Indian owned and controlled. While earlier the increase in foreign ownership beyond 26 percent was under the government route and required permission from the Foreign Investment Promotion Board the same is now permissible under the automatic route.[318]

The Insurance Act previously allowed foreign investment up to 26 percent of paid up equity capital in Indian insurance companies, which was amended with effect from December 2014, to 49 percent with permissions[319] and subsequently in March, 2016 to its current position.[320] The condition of Indian insurance companies being Indian owned and controlled, did not exist previously. The Ministry of Finance clarified the scope of Indian ownership and control pursuant to rules made in February 2015.[321]

The issue of need to increase foreign investment in insurance sector was first raised in 2002[322] and it took more than a decade for the change to happen. This draft legislation has gone through several amendments, including review by Parliamentary Standing Committee on Finance, and the Select Committee on Insurance Bill.

The IRDA has also initiated the process of amending its regulations to ensure compliance with the provisions of the Insurance (Laws) Amendment Act, 2015, including in relation to increase in the foreign investment limit. In October 2015, it issued guidelines on 'Indian owned and controlled', with the objective of bringing clarity for compliance with the manner of 'Indian owned and controlled'[323]. To ensure compliance with the said condition the Indian insurance companies are required to ensure that majority of directors (excluding independent directors) are nominated by Indian promoter(s)/ Indian investor(s). The appointment of key management person including Chief Executive Officer / Managing Director /Principal officer

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316 Section 2(7A) of the Insurance Act

317 Insurance companies incorporated in India

318 https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10316&Mode=0, Last accessed on 4th April, 2016

319 The Insurance Laws (Amendment) Act, 2015

320 Foreign Direct Investment (FDI) in India – Review of FDI policy –Insurance sector, Notification, Reserve Bank of India, 31st March, 2016

321 The Indian Insurance Companies (Foreign Investment) Rules, 2015, clarified that 'Indian Ownership' of an Indian Insurance Company means more than 50 percent of the equity capital in it is beneficially owned by resident Indian citizens or Indian companies, which are owned and controlled by resident Indian citizens. 'Indian Control of an Indian Insurance Company' was defined to mean control of such Indian Insurance Company by resident Indian citizens or Indian companies, which are owned and controlled by resident Indian citizens.

322 In April 2002, the IRDA requested the Law Commission of India (Law Commission) to review the provisions of Insurance Act and IRDA Act. The 190th report of the Law Commission (2004) noted, "*One issue that repeatedly surfaced during discussions with the industry was whether the law should be amended to permit greater foreign equity participation than the present limit of 26%. There were also questions raised about permitting insurance companies to have branches outside of India and to conduct business outside India. The Law Commission does not have the benefit of the views of the Government or the IRDA on these matters. In the Law Commission's perception these are matters on which a policy decision will have to be taken by the Government in consultation with the industry and the IRDA. The Law Commission is not making any research in this matter*."

323 No draft of such guidelines was issued in public domain for comment. The guidelines were issued under the powers conferred to IRDA under the IRDA Act, and. The guidelines are not only applicable to Indian insurance companies which may come into existence after Insurance Laws (Amendment) Act, 2015 comes into force or where Indian insurance companies propose to hike their foreign investment from the existing level, but also to those existing Indian insurance companies which do not intend to increase their current foreign stake from the existing level.

should be through the board of directors or by the Indian promoter (s) / Indian investor(s). In addition, where the chair of the Board has a casting vote, such person is required to be nominated by Indian promoter(s). The quorum for board meeting will be considered met if the majority of directors present are nominated by Indian investors, and even if no participation from foreign investors' represented directors happens. Existing Indian insurance companies are required to comply with the guidelines within a prescribed timeframe.[324]

*Raising capital from domestic sources*:

Previously, insurance companies were allowed to have capital only in form of ordinary shares. The Insurance Laws (Amendment) Act changed this situation and allowed insurance companies to have capital in such other forms, as may be specified by regulations by IRDA. Consequently, in November 2015, IRDA issued regulations allowing insurance companies to have capital in form of preference shares and subordinate debt, in accordance set out under the regulations.[325]

In addition, IRDA has recently has issued regulations regarding issuance of capital by Indian life insurance companies.[326] These regulations are in supersession of regulations made in 2011, which allowed insurance companies to raise share capital through public issue only on completion of 10 years from the date of commencement of business, or any other period prescribed by the central government. This was on account of erstwhile provision in the Insurance Act requiring dilution of promoter equity in excess of 26 percent of paid up equity capital of the insurer company after a period of 10 years.[327] This provision has been repealed by the Insurance Laws (Amendment) Act.

Indian insurance companies transacting in life insurance business are required to take prior written approval from the IRDA before approaching SEBI for public issue of shares and further issue under SEBI (Issue of Capital and Disclosure Requirements) Regulations.

IRDA has also issued regulations on transfer of equity shares of Insurance companies.[328] The regulations provide for prior approval of IRDA in case of transfer of shares likely to result in holding of transferee exceeding 5 percent of paid up equity capital of the company. The foreign investors are required to hold shares in insurance companies in accordance with Indian Insurance Companies (Foreign Investment) Rules, 2015.

## Expenditure by insurance companies

Two critical components of expenditure by insurance companies are commission payable to intermediaries and the expenses which management is allowed to make respect to different insurance product segments. Insurance regulations govern both these aspects of expenditures by insurance companies.

[324] The Indian insurance companies are required to submit an undertaking signed by Chief Executive Officer and Chief Compliance Officer, conforming the compliance of 'Indian owned and controlled' conditions. The undertaking is required to be accompanied by a board resolution to this effect, and an amended copy of agreement/ JV venture agreements, wherever applicable.
[325] IRDA (Other Forms of Capital Regulations) 2015
[326] IRDA (Issuance of Capital by Indian Insurance Companies transacting Life Insurance business) Regulations, 2015, issued in December 2015
[327] Section 6AA (now repealed) of the Insurance Act
[328] IRDA (Transfer of Equity Shares of Insurance Companies) Regulations, 2015, issued in April 2015

*Commission paid to intermediaries*

Key intermediaries in insurance sector include individual agents, corporate agents, brokers, and insurance marketing firms. The Insurance Act empowers the IRDA to restrict the payment of excessive remuneration to any person, by way of regulations issued in this regard.[329] Prior to the Insurance Laws (Amendment) Act, section 40A of the Insurance Act capped commission/ remuneration in any form in life insurance business, according to the type of insurance, term, and year of premium.[330] Section 40A was omitted by the 2014 amendment. The amendment, however, provides that IRDA shall take into account the nature and tenure of the policy and in particular the interest of the agents and other intermediaries concerned, while making regulations with respect to remuneration of intermediaries.[331]

At present, IRDA has linked commissions to premium collected on the relevant insurance products. Life insurance companies can offer participatory[332] or non participatory[333] products. Participatory products can be offered only under non-linked[334] platforms, while non-participatory products may be offered either under linked[335] or non-linked platforms.

Thus, three main product segments in the sector (relevant to study) are participatory non linked policies (such as endowment plans), non participatory non linked policies (such as term insurance policies), and non participatory linked policies (such as unit linked insurance policies).

The IRDA regulations provide that in case of other than single premium products, the first year commission/ remuneration can range from 15-35 percent of the premium, and for subsequent years it could range from 5-7.5 percent of premium (See Table 3.1 for details).

As per relevant IRDA regulations, commission or remuneration in any form for the procurement of all individual policies in respect of all distribution channels except the direct marketing shall not exceed 2 percent of the single premium, in case of single premium products. In case of other than single premium products, the commission/ remuneration are capped as follows:

[329] Section 31B

[330] Section 40A of the Insurance Act provided:

1. Where the policy grants an immediate annuity or a deferred annuity in consideration of a single premium, or where only one premium is payable on the policy, two per cent of that premium,
2. Where the policy grants a deferred annuity in consideration or more than one premium, 7.5 of the first year's premium, and two per cent of each renewal premium payable on the policy, and
3. In any other case, 35 percent of the first year's premium, 7.5 percent of the second and third year's renewal premium, and thereafter 5 percent of each renewal premium payable on the policy. However, during the first ten years of business, an insurer can pay insurance agent up to 40 percent of first year premium payable.

[331] Section 40 of the Insurance Laws (Amendment) Act

[332] Policies with participation in profits, i.e. which are entitled for share in surplus (profits) during the term of the policy

[333] Policies without participation in profits, i.e. which are not entitled for any share in surplus (profits) during the term of the policy

[334] Non linked products are those where benefits assured are payable on the occurrence of specified event which is explicitly stated at the outset and not linked to any index or benchmark

[335] Linked products are those where benefits are partially or wholly dependent on the performance of underlying assets or approved external index/ benchmark, which is linked to the products

| Table 3.1: Cap on premium/ remuneration | | | |
|---|---|---|---|
| **Premium paying terms** | **Maximum Commission or remuneration in any form as % of premium** | | |
| | **1st year** | **2 & 3year** | **Subsequent years** |
| 5 | 15 | 7.5/5(*) | 5 |
| 6 | 18 | 7.5/5(*) | 5 |
| 7 | 21 | 7.5/5(*) | 5 |
| 8 | 24 | 7.5/5(*) | 5 |
| 9 | 27 | 7.5/5(*) | 5 |
| 10 | 30 | 7.5/5(*) | 5 |
| 11 | 33/30(*) | 7.5/5(*) | 5 |
| 12 years or more | 35/30(*) | 7.5/5(*) | 5 |

* The maximum commission or remuneration:
(a) For brokers shall be
i) 30% in the first year for policies with premium paying term 10 and above; and
ii) 5% in the subsequent years for all premium paying terms
(b) During the first ten years of a life insurer's business for all intermediaries, except for brokers, shall be 40% in the first year for policies with premium paying term 12 and above

In addition, with respect to unit linked insurance products, IRDA has mandated distribution of overall charges in an even fashion during the lock-in period. The objective was to avoid front loading of expenses, and consequent high first year premiums.[336]

*Management expenses*

Like commission/ remuneration to intermediaries, insurance regulations links management expenses to premium collected through different product segments by the insurer. Rule 17D of the Insurance Rules, 1939 describes the caps on management expenses that any life insurance company can incur from the premium income. Expenses of management refer to all charges incurred either directly or indirectly and include commission payments of all kinds, operating expenses and expenditure capitalised. The rule takes into account the size, age of the insurance company as well as the type of business segment, for limiting the expenses.

There are also certain exemptions provided, for instance accounting for the high initial set-up costs that would be incurred, private insurance companies are exempt for a period of five years from the commencement of business operations, from compliance of the mentioned rules.[337]

## Retention of consumers

Life insurance is a long term product and would translate into value for all stakeholders if it completes its full term through regular payment of premium. Customer retention is critical to this industry and persistency is the term used to describe the ability to renew policies till it reaches maturity. It is the percentage of business retained which can be calculated as the

[336] IRDA circular on Unit Linked Insurance Products dated 28 June 2010, available at https://www.irdai.gov.in/ADMINCMS/cms/Uploadedfiles/CIRCULAR_ULIP%2028062010.pdf. Accessed on 11 February 2016

[337] Insurance Rules are available at http://financialservices.gov.in/Insurance/Acts/Insurance%20Rules%201939.pdf. Accessed on 11 February 2016

proportion of policies remaining at the end of the period out of the total policies in force at the beginning of the period.[338] Retention of customers is also important to project adequate revenue growth and attract investments.[339]

The regulatory scenario around retention/ persistency has been subject to change in recent past. The IRDA guidelines on individual agents for persistency of life insurance policies[340] recognise the negative impacts of low persistency on the sector as a whole as well as the role that can be played by intermediaries to correct this scenario by putting in place minimum standards of performance. The guidelines states that agents should (i) avoid soliciting unsuitable products, (ii) ensure greater transparency by providing correct and complete details of the product and (iii) consider the needs of the policyholders.

The important aspects such as persistency rate, orphan policy and deferred commission have been defined. The guidelines originally provided that all renewals made prior to financial year 2014-15, the average persistency rate for each agent for the years 2011-12, 2012-13 and 2013-14 needs to be at least 50 percent in terms of number of policies as well as premium procured. Further, from financial year 2014-15, the same was required to be at least 75 percent for such agent. The renewal of the agent license was based on meeting these above conditions. The agents were required to maintain a record of the policies sold as well as their persistency on a year to year basis and the insurer was required to endorse by the same was at the end of the year.

Within two months on their coming into force, the guidelines were revised in September 2011. The revision set uniform average persistency rate as 50 percent which was to be reckoned on only on number of policies, thus excluding procurement of premium from the calculation of persistency. The revision also clarified that while arriving at the persistency rate, policies with 'auto cover' feature embedded as per File & Use approval may be treated as in force during the said 'auto cover period'. Further all the policy exits by way of death, maturity and in-force surrenders may also be exempted in determining the exposure to persistency calculation. The persistency rate requirements were made effective for all agency renewals that were due from 01st July, 2014.[341] Admittedly, the revisions were made on the basis of representations made by the industry.

Further modifications were made in the guidelines within two months, in November 2011. The modifications removed the requirement for insurers to endorse the records. It also stated that these guidelines (except certain conditions) would also be applicable to corporate agents.[342]

[338] http://www.lifeinscouncil.org/component/content/article/106-whats-new/478-exposure-draft-persistency-of-life-insurance-policies, Accessed on 4th February, 2016

[339] "There is a distinct link between persistency and profitability… . Any valuation should reflect the persistency track record of an insurer..", Deepti Bhaskaran, *Need more transparency in participating insurance plans*, 23 December 2015, Livemint, at http://www.livemint.com/Money/utjj10D73Hcx1z29Xy4qGK/Need-more-transparency-in-participating-insurance-plans.html. Accessed on 11 February 2016

[340] The guidelines were originally issued on 11 February 2011 (and came into effect on 01 July 2011) and are available at https://www.irdai.gov.in/ADMINCMS/cms/Circulars_Layout.aspx?page=PageNo1065&flag=1. Accessed on 11 February 2016

[341] The revision is available at https://www.irdai.gov.in/ADMINCMS/cms/frmGuidelines_Layout.aspx?page=PageNo1528&flag=1. Accessed on 11 February 2016.

[342] The modifications are available at https://www.irdai.gov.in/ADMINCMS/cms/frmGuidelines_Layout.aspx?page=PageNo1556&flag=1. Accessed on 11 February 2016

In order to ensure uniform and systematic methodology in calculation of persistency rate in all regulatory reporting and internal assessments, IRDA issued relevant methodology and other requirements pursuant to a circular dated 23 January 2014. Insurers were required to submit a report on persistency along with appointed Actuary's Annual Report. The persistency is required to be calculated in terms of premium amounts and number of policies.[343]

The guidelines were further modified in February 2014 to provide that renewal of individual agency license and corporate agency license will not be subject to meeting the persistency rates.
Further, all life insurers were required to have their own company specific persistency criterion for renewal of individual and corporate agency from 1st July 2014, thus removing the requirement of maintaining 50 percent persistency rate.[344]

In addition to guidelines related to persistency, IRDA requires life insurance companies to report conservation ratio on a periodic basis.[345] Conservation ratio is the ratio between renewal premium of current year and renewal and first year premium combined of the previous year.

[343] The circular is available at https://www.irdai.gov.in/ADMINCMS/cms/Circulars_Layout.aspx?page=PageNo2184&flag=1. Accessed on 11 February 2016

[344] The revisions are available at https://www.irdai.gov.in/ADMINCMS/cms/frmGuidelines_Layout.aspx?page=PageNo2207&flag=1. Accessed on 11 February 2016

[345] IRDA Master Circular on preparation of financial statements and filing returns of life insurance business dated 11 December 2013, available at https://www.irdai.gov.in/ADMINCMS/cms/Circulars_Layout.aspx?page=PageNo2138&flag=1. Accessed on 11 February 2016

# Chapter 4
# Assessment of Baseline Scenario

A critical component of regulatory impact assessment involves understanding the existing scenario and assessing how the regulations are influencing behaviour of relevant stakeholders in sector to achieve what is prevalent. Assessment of baseline scenario is also necessary to design correct alternatives to achieve the desired scenario in the sector.

As indicated earlier, this study deals with three critical areas of regulations which influence investments in the sector, viz. regulations on: i) investors with respect to conditions on investing; ii) insurers about expenditure on operations and commission; and iii) retention of consumers. Following sections highlight existing scenario on these issues in the life insurance sector.

## Investments in insurance companies

*Foreign investment*

The total paid up capital (excluding share premium and share application money) of the life insurance companies as on 31st March, 2015 was Rs. 26,244.14 crore, of which the total paid up capital of private sector was Rs. 26,144.14 crore. During 2014-15, an additional capital of Rs. 305.63 crore was brought into the industry by the private sector insurers.[346]

According to the public disclosures filed by life insurance companies, between September 2014 and September 2015, the total paid up capital (excluding share premium) increased by merely Rs. 23.57 crore. However, most of this was increase in non-promoter shareholding.[347]

It might be recalled that the cap on foreign investment in the sector was increased from 26 percent to 49 percent, with effect from December 2014. Absence of increase in shareholding of foreign investors within one year of allowing greater investment is contrary to experience of the industry in early 2000s, when private sector was allowed to operate in the sector, with foreign investment up to 26 percent. IRDA was incorporated in April 2000 and it started inviting applications for the registration in August 2000. Within first eight months, seven life insurance companies and three non-life insurance companies with foreign partners were granted registration.

As per the public disclosures of HDFC Standard Life Insurance Company Limited, Housing Development Finance Corporation Limited proposes to transfer 179,539,209 equity shares of HDFC Standard Life Insurance Company Limited to Standard Life (Mauritius Holdings) 2006 Limited pursuant to the Share Sale and Purchase Agreement dated August 14, 2015. The proposed transfer is subject to regulatory approvals from relevant authorities.[348] This equals to around Rs. 180 crore of paid up share capital (excluding share premium).

[346] IRDA Annual Report 2014-15

[347] Increase in non-promoter shareholding in ICICI Prudential Life Insurance was around Rs. 22.01 crore during the mentioned period. The public disclosures of life insurers are available at https://www.irdai.gov.in/ADMINCMS/cms/NormalData_Layout.aspx?page=PageNo764&mid=31.1

[348] Form L9 filed by HDFC Standard Life Insurance Company Limited for quarter ended September 2015.

Further, according to India Brand Equity Foundation, following investments are being planned in the life insurance sector:[349]

- Insurance firm AIA Group Ltd has decided to increase its stake in Tata AIA Life Insurance Co Ltd, a joint venture owned by Tata Sons Ltd and AIA Group from 26 per cent to 49 per cent.
- Canada based Sun Life Financial Inc plans to increase its stake from 26 per cent to 49 per cent in Birla Sun Life Insurance Co Ltd, a joint venture with Aditya Birla Nuvo Ltd, through buying of shares worth Rs 1,664 crore (US$ 249 million).
- Nippon Life Insurance has signed definitive agreements to invest Rs 2,265 crore (US$ 348 million) in order to increase its stake in Reliance Life Insurance from 26 per cent to 49 per cent.
- Bennett Coleman and Co. Ltd (BCCL) is set to buy Religare Enterprises Ltd's entire 44 per cent stake in life insurance joint venture Aegon Religare Life Insurance Co. Ltd. The foreign partner Aegon is set to increase its stake in the joint venture from 26 per cent to 49 per cent.
- State Bank of India has announced that BNP Paribas Cardif is keen to increase its stake in SBI Life Insurance from 26 per cent to 36 per cent. Once the foreign joint venture partner increases its stake to 36 per cent, SBI's stake in SBI Life will get diluted to 64 per cent.

However, as in case of HDFC Life Insurance, all these plans are subject to regulatory approvals and compliance with relevant regulatory conditions. While it appears that, after the passage of Insurance Laws (Amendment) Act, 2014, foreign investors are interested to invest in the sector, stringent regulatory restrictions and related conditions have forced them to hold back their plans.
As indicated earlier, these conditions include compliance with domestic owned and controlled condition within the required time frame by existing as well as new insurers, confusion created by multiple regulatory instruments issued by different regulators, and little time available with insurers to comply with regulatory changes issued as a result of changes in Insurance Act. Such regulatory complexities holding back the investments were validated through stakeholder interactions and available literature.[350]

And such complex regulatory requirements have been put in place after delay of close to a decade in increasing the investment limit the sector. According to report of Standing Committee on Finance (2009) on the Insurance Laws (Amendment) Bill, 2008, the government submitted that the increased foreign investment was required to maintain solvency margin and additional capital for growth of business. IRDA had estimated that the total capital requirement of the insurance sector was Rs. 61,200 crore over five years, which cannot be expected to be contributed from domestic promoters or domestic capital market. However, the Standing Committee was not convinced by the rationale submitted by government/ IRDA, and the latter's failure to consider alternative capital sources.

The Insurance Bill was thereafter referred to a Select Committee on Insurance Bill. The Central Government, through the Department of Financial Services explained that the

[349] India Brand Equity Foundation, *Insurance Sector in India: Investments*, December 2015
[350] George Mathew, *49% insurance FDI: 6 months later foreign firms still elusive,* Indian Express, 16 October 2015, at http://indianexpress.com/article/business/business-others/49-insurance-fdi-6-months-later-foreign-firms-still-elusive/, accessed on 19 October 2015, Subhomoy Bhattacharjee, *Why 49% FDI is still not good news for the insurance sector,* Indian Express, 17 July 2015, at http://indianexpress.com/article/india/india-others/why-49-fdi-is-still-not-good-news-for-the-insurance-sector/ accessed on 12 October 2015

rationale behind increasing the FDI limit was that the insurance companies were regulated by stringent solvency norms and continuously required additional capital for growth, which partly get invested in key sectors like infrastructure. IRDA has estimated that the additional capital requirement of the insurance sector would be Rs. 55,000 crore (Rs.44,500 crores for the life sector and Rs. 10,500 crores for the non-life sector) over the next five years, which may not be taken care of by the limited domestic sources.

In its report dated December 2014, the Select Committee recommended increase in the foreign investment cap to 49 percent. It noted:

"*There is a requirement of huge amount of capital as defined by the regulator for stipulated solvency levels to maintain the trust level of stake holders in life insurance companies through solvency under all circumstances. This enhanced foreign equity will not only help in expansion of insurance coverage, comprehensive and better portfolio management, enable growth of pension sector but also potentially enable transfer of technical knowhow and other better consumer services through improved practices and competitive pressures. The Committee observed that IPOs may not be the best route for raising capital in the insurance sector as FIIs face constraints due to sectoral foreign equity caps.*"

Consequently, the sub optimal regulatory scenario with respect to investments in life insurance sector is delaying potential investments to the tune of Rs. 50,000 crore, which is adversely affecting the growth potential of the industry and its ability to reach out to the masses and uninsured populace.

*Domestic investment*

As indicated earlier, insurance companies were previously allowed to have capital only in form of ordinary shares, situation which was changed pursuant to the Insurance Laws (Amendment) Act. As the result of reforms issued pursuant to the amendment act, the regulator has issued guidelines with respect to raising of capital by life insurance companies, and transfer of equity shares. It appears that the delay in passage of insurance amendment has resulted in opportunity cost for insurers to access domestic sources for raising capital.

It has been reported that earlier regulations on initial public offering by insurance companies, which required 10 years in operation, specific embedded value, restricted interested insurers from accessing domestic capital markets. With the passage of insurance amendment after a huge delay, the insurers are expected to seriously consider availing domestic sources of capital.[351] However, it has also been reported that the necessity of multiple approvals from IRDA and SEBI, as prescribed in the current regulations, has the potential to act as roadblocks in the capital raising process of the insurance companies.[352] Such regulatory complexities might have held back potential investors in the insurance sector and deprived life insurance companies of much needed investments.

[351] John Loh, *India pushes on with IPOs from life insurance sector*, Global capital, 17 September 2015, at http://www.globalcapital.com/article/tcb0dcq4hspr/india-pushes-on-with-ipos-from-life-insurance-sector. accessed on 17 February 2016

[352] Saraswathy and Lele, *Insurance IPOs still 2-3 years away*, Business Standard, 04 August 2014, at http://www.business-standard.com/article/finance/insurance-ipos-still-2-3-years-away-114072901018_1.html, accessed on 01 February 2014

## Expenditure by insurance companies

As indicated in earlier, insurance regulations have linked commission/ remuneration to intermediaries and operating expenses to the premium collected by insurance intermediaries. For the financial year 2014-15, the average commission expense ratio[353] for first year with respect to private sector life insurers was 8.74 percent, while the renewal commission expense ratio was 2.42 percent. Further, the average operating expenses ratio[354] for private life insurers was 16.36 per cent in 2014-15.[355]

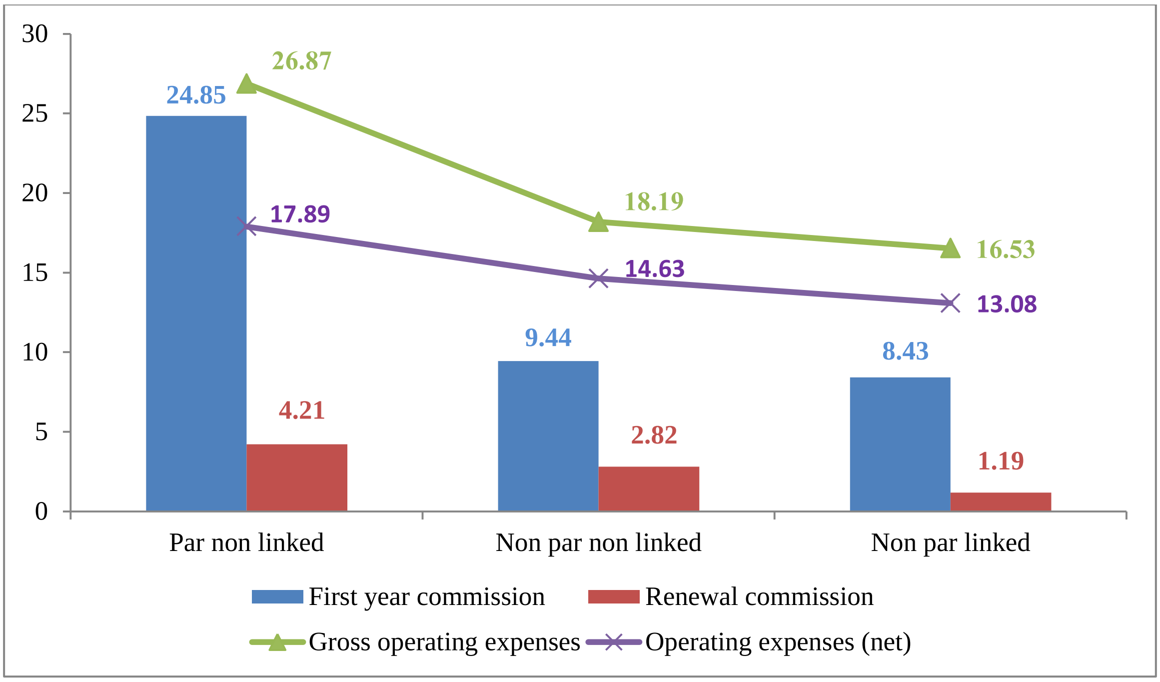
The commission expense ratio and operating expense ratio for non linked products in higher than linked products. This appears to be a result of higher cap on commission and management expenses for non-linked products than for linked products. This, understandably, was a result of high misselling and mid-course surrender of policies, experienced in unit linked insurance product segment. The commission and management expense cap for all products in non-linked segment appears to be similar.

Despite having similar caps, the average commission for participatory products appears to be more than twice that for the non participatory products, within the non linked product segment. The management expense in the former also appears to be significantly higher than the latter (see Figure 4.1 below and Annexure 1 for related discussion).

Perhaps, this is on account of attractiveness of participatory products when compared with non participatory products. Participatory products offer additional incentives like bonus at the discretion of insurer, and endowment plans offer survivor benefits. Such incentives are not available in case of non participatory products which are pure risk/ term products, and the insurance benefit is contingent upon happening of the event (death) within the coverage period. However, such non participatory non linked products are cheaper when compared with other product segments.

[353] Commission as a percentage of premium
[354] Operating expenses as a percent of gross premium
[355] IRDA Annual Report 2014-15

**Figure4. 1 - Comparison of commission and operating ratios**




*Source: Public disclosures by select life insurers for six month ending September 2015*

In addition, the insurance regulations allow front loading of expenditure by permitting high first year commission. This naturally makes procurement of new business a focus for intermediaries. Consequently, during 2014-15, the first year premium commission expenses for private sector life insurers was Rs. 3,043.38 crore while renewal premium commission expenses was Rs. 1,299.16 crore. High upfront costs create barriers to entry, delayed break-even, and deferred expansion plans.

Further, as indicated earlier, rule 17D of the Insurance Rules, 1939 caps management expenses. It has been reported that for the financial year 2014-15, nine companies were not complying with said required, and action was initiated against such nine private sector life insurance companies.[356] In order to address the situation, life insurance companies will have to improve operational efficiency and commission ratio, for which they might have to rely on external expertise, technology and investments.

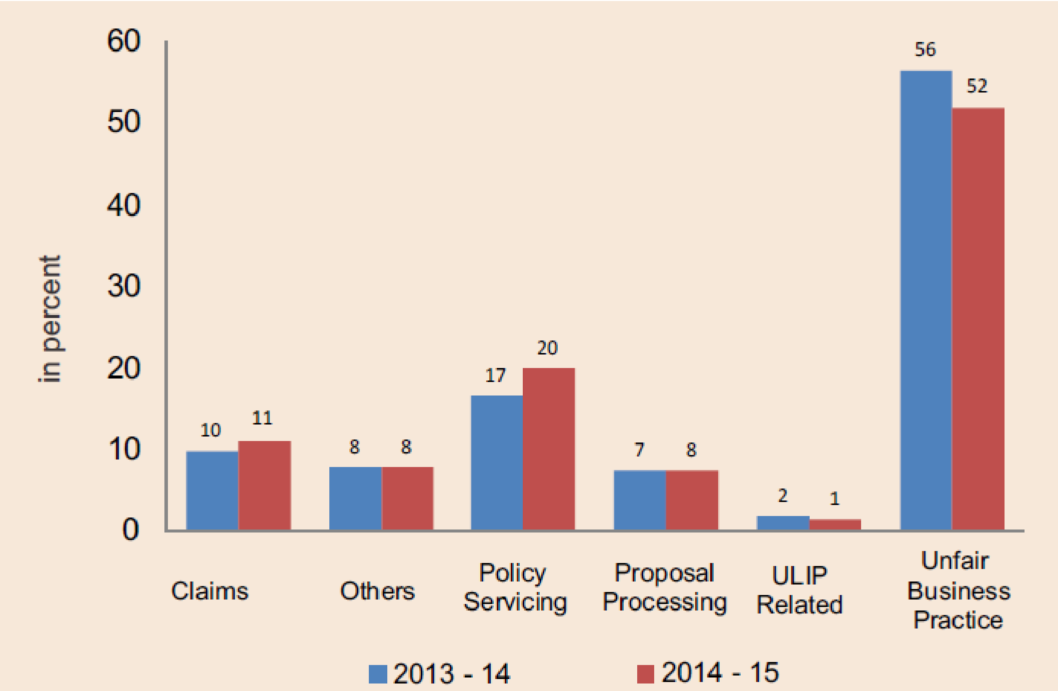
Owing to lower operating costs, while insurers are interested to push for non-participatory products, intermediaries are interested to push for participatory and linked products, which offer additional incentives over pure risk products, and consequently higher commission (close to respective regulatory caps). Regulatory push also appears towards pushing non linked products. However, management expenses (and commission payouts) for non-linked products are higher. Hence regulatory push for such policies, without availability of adequate capital with insurers, might not be sustainable in the long term. As a result, the regulations might need to be relooked to provide appropriate incentives (with respect to availability of capital) to insurers to sell non linked insurance policies for long term.

Also, the aforesaid conflict of interest between critical stakeholders groups has the potential to result in adverse consequences for the vulnerable consumers. Experts suggest that

[356] Annual Report 2014-15, Insurance Regulatory and Development Authority of India, November 2015

insurance agents overwhelmingly recommend products which provide high commissions to the agent and are unsuitable for the customers. This is greater for customers who appear to be less financially literate.[357] Consequently, the possibility of misselling non linked insurance products is high. The annual report of IRDA also suggests that complaints of unfair business practice comprise more than 50 percent of the total complaints received by life insurance companies (See figure 4.2).

**Figure4. 2 - Classification of Life Insurance Complaints during 2013-14 and 2014-15**




*Source: IRDA Annual Report 2014-15*

Misselling can have several negative consequences for insurers. They might lose consumers who leave the policy mid-way upon realising the unsuitability of the policy. In addition, claims of misselling against insurance companies could increase their contingent liabilities, and adversely impact insurer's reputation. Expansion of business and customer onboarding might become more difficult which might drag down revenue expectations of the insurer. This is turn could adversely impact valuation of insurance companies, and their ability to attract investments.

## Retention of consumers

[357] Santosh Anagol, Shawn Cole, and Shayak Sarkar, *Understanding the Incentives of Commissions Motivated Agents: Theory and Evidence from the Indian Life Insurance Market*, Working Paper 12-055, Harvard Business School, Jan. 2012, cited from Sumit Bose et al, *Report of the Committee to recommend measures for curbing mis-selling and rationalising distribution incentives in financial products*, Ministry of Finance, Government of India, August 2015

As indicated earlier, to push for customer retention, IRDA has been requiring insurers to frame company specific criteria for calculation of persistency ratio, and report the relevant ratio in public domain on periodic basis.

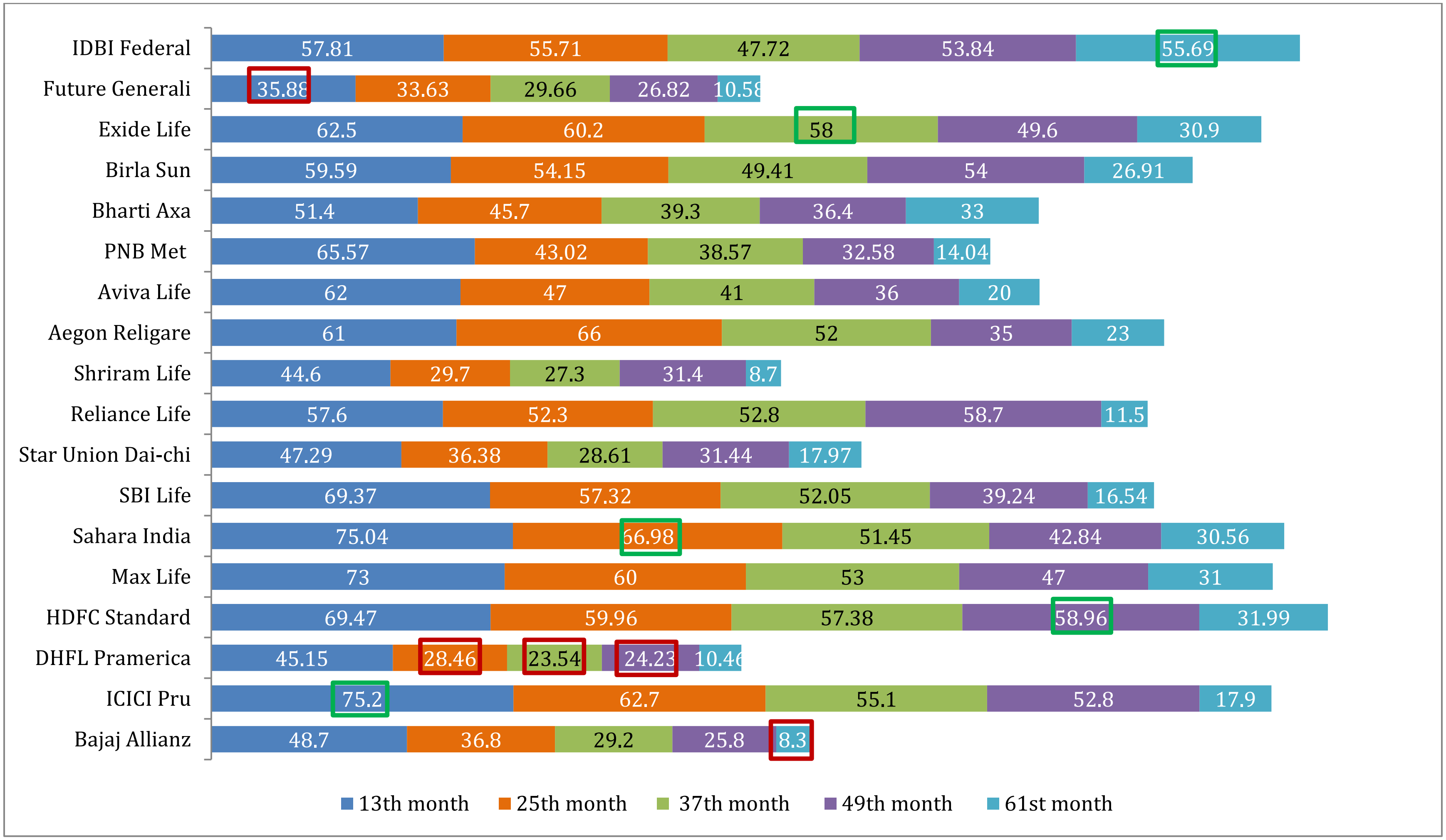
A review of public disclosures of 18 life insurance companies for six months period ended September 2015 reveal that in close to 60 percent of disclosures, persistency rate is less than 50 percent (See Figure 4.3 below and Annexure 2 for related calculations). It might be recalled that IRDA had earlier required maintaining persistency ratios of at least 50 percent.

It also appears that persistency spread between companies is significant and only high performer insurers come close to maintaining decent persistency levels. Unsurprisingly, these insurers are well capitalized, highlighting the relation between capital and persistency levels. Perhaps, this also indicates to a vicious cycle wherein capital is required to maintain persistency and investors (who can provide capital) are attracted towards those companies which have high persistency, an indicator of adequate revenue generation potential.

India fares poorly when compared with rest of the world on insurance persistency. Average 13$^{th}$ month persistency in India is around 58 percent while the average for OECD countries (Organisation for Economic Co-operation and Development) is close to 90 percent. The 61$^{st}$ month average for Indian insurance companies excluding LIC (44 percent) is close to 28 percent while the same for OECD countries is around 60-65 percent.[358] Consequently, urgent measures are required to address the situation and improving the persistency rates amongst private life insurers.

[358] http://www.livemint.com/Money/5fIh4IrUV4zsj9H5s5UJwI/Why-are-life-insurance-policies-abandoned-midway.html, Accessed on 5$^{th}$ February, 2016

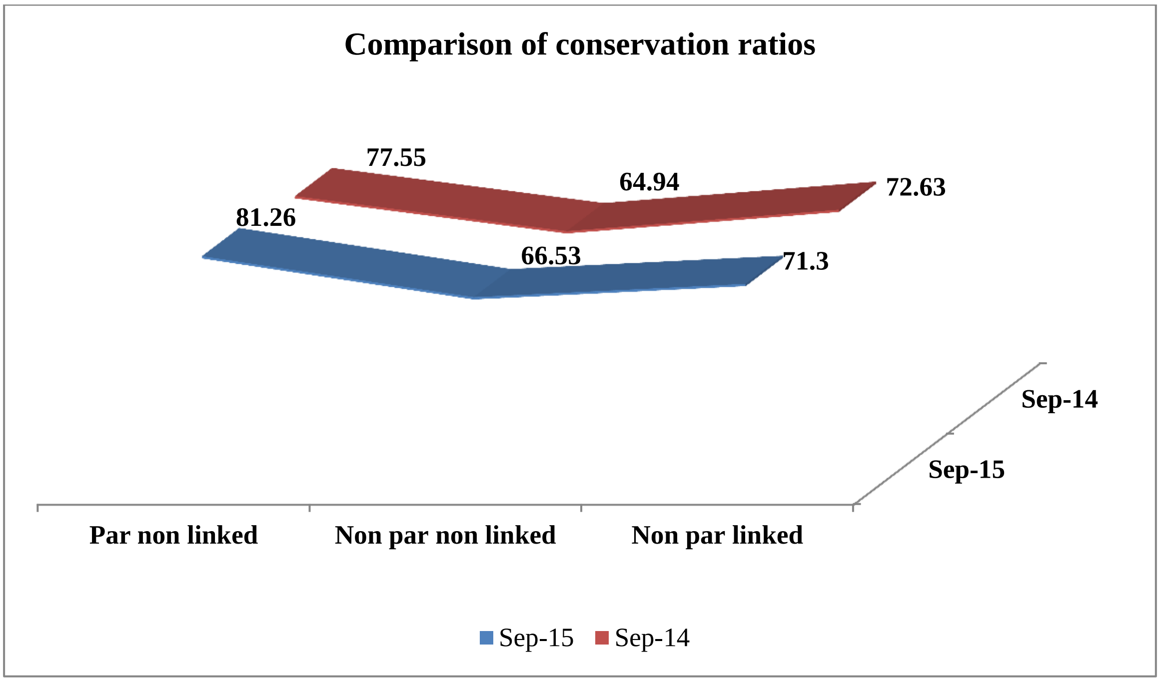
**Figure4. 3 - Comparison of persistency ratios of life insurers**




*Source: Public disclosures by select life insurers for six month ending September 2015*

In addition to persistency, conservation ratio is one of the key indicators of insurers' ability to retain customers. It is an indicator of how much of business underwritten in the previous years is getting renewed each year.[359] It appears that the conservation ratio of non-participatory non linked policies has been consistently lower that other policy segments (See figure 4.4 and Annexure 3 for related calculations).

**Figure4. 4 - Comparison of conservation ratios**



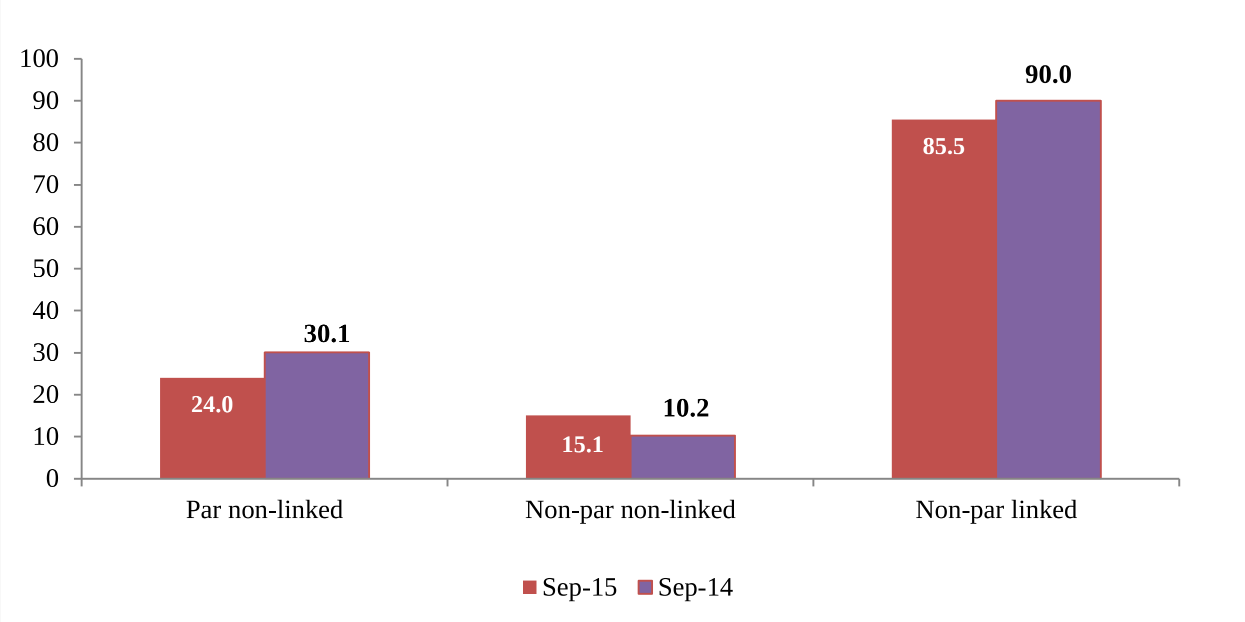

*Source: Public disclosures of select insurers for six month ended September 2015*

Low persistency and conservation can be interpreted as mid-course surrender of policies by consumers. Upon realising that the product sold is not suitable for them, consumers stop paying renewal premiums. In the process, they also lose significant portion of their initial investments made in procurement of policies.

During the six months ending September 2015, surrender payouts of traditional non linked policies (participatory and non participatory non linked policies) was Rs. 4.59 billion, for the nine life insurance companies for which data is available (See Annexure 4 for related calculations)

[359] Srikumar Bondyopadhyay, *Policy renewal a headache for private life insurers*, The Telegraph, 11 March 2009, at http://www.telegraphindia.com/1090311/jsp/business/story_10656114.jsp

**Figure4. 5- Comparison of average surrender payout ratio**




*Source: Public disclosures by select insurers for the six month period ending September 2015*

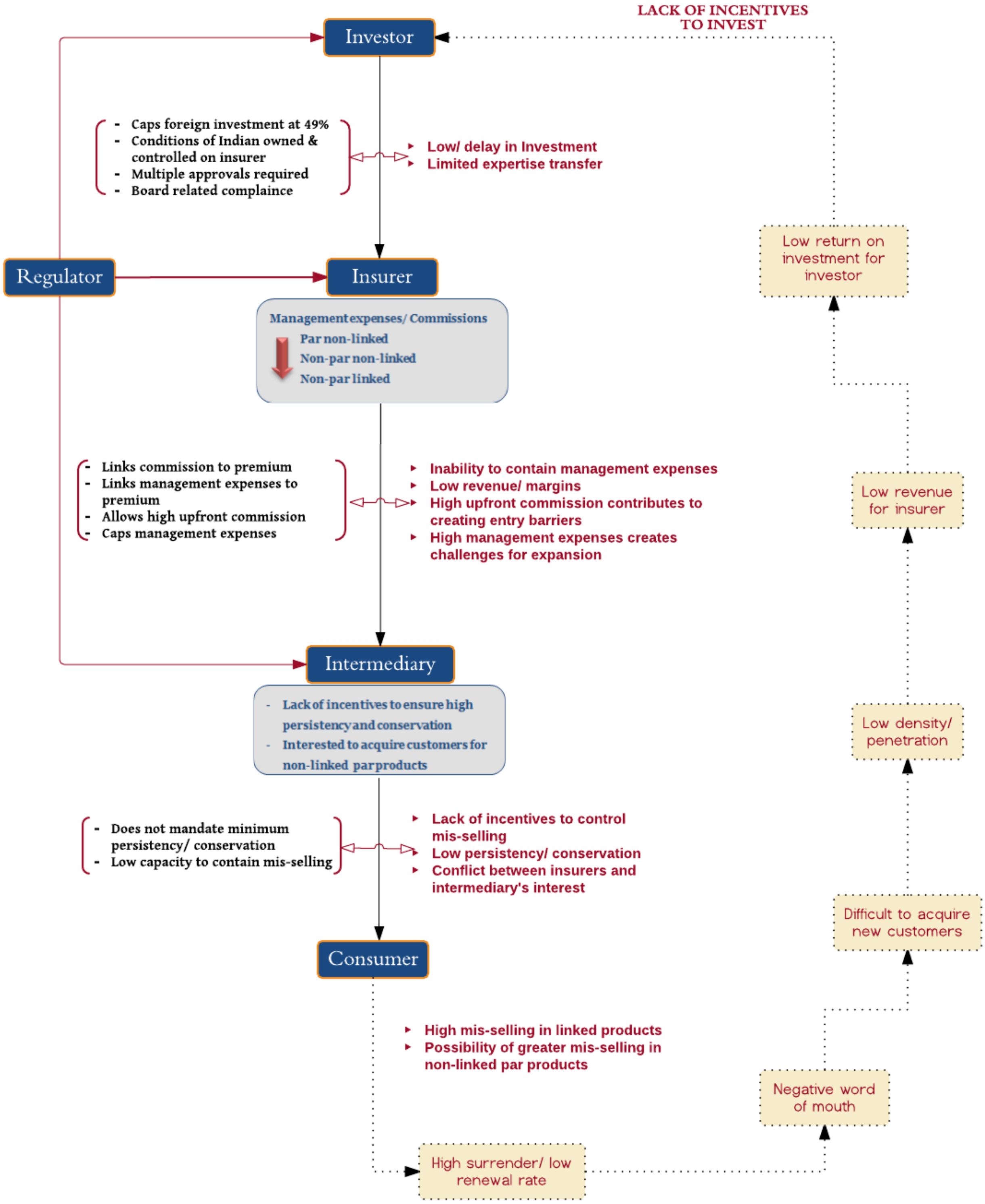
As indicated in Figure 4.5, surrender of non participatory non linked policies has increased during past year, with surrender payout increasing by Rs. 30.11 million. This is consistent with finding that conservation of such pure risk policies in lowest.

The surrender payouts for non participatory linked policies reduced substantially by Rs. 60.03 billion to Rs. 24.58 billion, however, the reduction in non-linked policies (on a consolidated basis) was merely Rs. 0.10 billion. This indicates to the lack of incentives to prevent/ reduce surrender of traditional non linked policies. High surrenders could be on account of actual return differing from promised returns, poor need gap assessment at the time of sale, negative experience with customer service and complaint management, new product options, financial crisis of policyholder, lack of knowledge of policyholder with respect to terms and conditions[360], mis-selling,[361] among others.

Surrender usually means movement of consumers away from the relevant product segments. This effectively results in lower revenue potential for insurers in the longer term, reducing attractiveness of the insurance company for potential investor. Consequently, if the incentives to stakeholders are not realigned to prevent surrender of non linked policies, insurance companies might not be able to attract requisite investments in the long term.

[360] The definitive guide to improving insurance persistency in India, Aureus Analytics
[361] Report of the Committee to recommend measures for curbing mis-selling and rationalizing distribution incentives in financial products, Ministry of Finance, Government of India, August 2015

## Figure4. 6 - Diagrammatic representation of baseline scenario




*Source: Authors' analysis*

# Chapter 5
# Designing regulatory alternatives

The prevailing regulatory architecture in life insurance sector has contributed to existing state of affairs, which has attracted less than adequate investments. Regulations around investors, insurers and intermediaries in the sector appeared to have inhibited growth of the sector. However, investments do not merely look at the text of regulations, but also the process of regulation making, which is an indicator of certainty and predictability of regulatory architecture.

Consequently, the following sections discuss possible regulatory alternatives to existing text of select regulations, along with the process of regulation making.

## Reforming the design of regulations

**Expenditure by insurance companies**

*Regulatory proposal: Increase in cap on commission and management expenses for participatory non linked policies*

To regulate expenditure by insurance companies, IRDA has issued draft regulations on expenses of management[362] of life insurers and commissions/remuneration[363] payable by life insurers.

These draft regulations link expenses of management[364] as well remuneration/ commission to the premium collected. For instance, regulation on management expenses delves into different product segments and caps expenses between 12-25 percent of renewal premiums, depending on nature of product, with higher caps for pure risk products. Similarly, the regulation on commission/ remuneration provides different caps for different product segments, ranging from 35-50 percent in the first year, and 5-10 percent in renewal years, with higher caps for pure risk products.

The underlying objective to these draft regulations is to push for sale of non-participatory non linked policies. The presumption seems that allowing higher management expenses and commission/ remuneration for non-participatory non linked policies would increase uptake of such policies.

Existing regulations allow first year commissions up to 30 percent and renewal commission up to 7.5 percent. However, average commissions are not more than 10 percent and 3 percent, respectively, in case of non participatory non linked policies. Also, the gross operating expenses ratio for such pure risk products is merely 20 percent, much below allowed cap (See Figure 4.1, Annexure 1 and related discussion in Chapter 4).

[362] Exposure draft of the IRDA (Expenses of insurers transacting the business of life insurers) Regulations, 2015, issued on 22 December 2015

[363] Exposure draft of the IRDA (Payment of commission or remuneration or reward to insurance agents and insurance intermediaries) Regulations, 2016, issued on 13 January 2016

[364] Defined in the exposure draft as all expenses in the nature of operating expenses including commission, remuneration to the insurance agents, intermediaries and insurance intermediaries which are charged to Revenue Account.

On the other hand, the expenditure and commission on participatory policies are close to caps allowed in respective product segments. This indicates that while insurers are pushing for linked participatory products, owing to high margins, and intermediaries are pushing for non -linked participatory products, owing to highest commissions, the sale of non-participatory non linked policies is lagging. Consequently, it is difficult to establish causal link between the regulation of management expenses and commission and the objective of popularising non participatory non linked policies.

*Expected impact:*

On the basis of review of baseline scenario, it is unlikely that the regulatory proposal of allowing higher commission/ management expenses for non-participatory non linked policies will increase their sale.

On the contrary, the proposal caps management expenses at 25 percent of the premium. Evidence suggests that average gross operating expense ratio for participatory non linked policies is more than 25 percent (See Figure 4.1 and Annexure 1), and consequently the management expenses ratio is expected to be higher. A reduction in the allowable management expenses could have negative impact on sale of participatory non linked policies. Reduction in sale of endowment policies, hitherto most attractive segment, has the potential to lower the revenue projections and profitability,[365] reduction in rate of increase of insurance penetration and density and thereby lowering the attractiveness of sector for investor community.

<u>*Alternative 1: Comparative disclosure on costs to consumer*</u>

The inherent design of non participatory non linked products (no additional incentive over and above the agreed amount, as against possibility of bonus in participatory policies and benefit from increase in prices of linked products in linked policies) puts them at disadvantage against the other product segments.

Low cost is the only advantage which such policies have, over others, which needs to be leveraged if the sale of this product segment needs to be popularised. Consequently, disclosure on cost of comparable products in different product segments could be mandated to highlight the advantage of non participatory non linked policies. While the IRDA regulation on insurance advertisement requires clear disclosure on cost of insurance product, there is no requirement to provide costs of comparable products.[366] Expert committees have also made similar recommendations regarding product cost comparisons.[367]

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[365] Deepa Nair, *IRDAI crackdown on 'participatory products' may impact profitability*, Hindu Business Line, 18 February 2016, at http://www.thehindubusinessline.com/money-and-banking/irdai-crackdown-on-participating-products-may-impact-profitability/article8253684.ece, accessed on 21 February 2016

[366] IRDA Master Circular on Insurance Advertisement, August 2015, at https://www.irdai.gov.in/ADMINCMS/cms/Uploadedfiles/Master%20Circular%20on%20Advertisements%20of%20Aug%202015.PDF. Accessed on 18 February 2016

[367] Sumit Bose Committee on Incentive Structure notes, "*For comparison, the cost of a pure life cover as in a term policy for a similar life and tenor should be disclosed alongside such that a customer is able to evaluate the true value of the product.*"

The current regulations also govern the illustration of benefits in insurance advertisement has been regulated. However, IRDA has observed non-compliance with relevant conditions.[368] Experts have also pointed out to violation of IRDA regulation on insurance advertisement by insurance companies.[369] Consequently, the insurance regulator needs to focus energies in enforcing regulations and ensuring compliance.

*Expected impact:*

Requirement of improved and comparative disclosure of costs of similar products across product segments is expected to consumers' bringing home the fact that non participatory non-linked policies are pure risk least expensive products. Such realisation is expected to increase the sale of such products and aid in attainment of regulatory objective. With increased consumers' interest in this product segment, the intermediaries are expected to focus on selling such products, which will consequently increase revenues for intermediaries and insurers from this product segment, and increase insurance penetration and density. Increased revenue potential for insurers is expected to increase attractiveness of industry for potential investors.

However, increase in disclosure is expected to marginally increase the costs for insurers. The monitoring, supervision and enforcement costs for insurers are also expected to increase moderately.

Upon comparison, the benefits of improved and effective disclosure regime to the economy are expected to outweigh the costs it will impose on stakeholders.

*Alternative 2: Check surrender and misselling*

As insurers and intermediaries have limited incentives to sell non participatory non linked policies, these policies tend to suffer neglect of these stakeholder groups. Evidence suggests that this could have resulted in increase in surrender (perhaps, as a result of misselling) of such policies, when all other policy segments are witnessing reduction in surrender (see Figure 4.4, Annexure 4 and related discussion in Chapter 4). Consequently, there is a requirement to shift regulatory energy from regulating commissions and operating expenses of different product segments to checking surrender and misselling of policies.

At present, regulations exist with respect to calculation and amount of surrender pay-outs.[370] However, it appears that there is no regulation to investigate reasons for surrender. Similarly, regulation requires insurers to resolve consumer grievance regarding incorrect surrender value, delay in payment of surrender value within specified time period, and misselling[371], but there is no regulation on linking surrender to misselling. In addition, it appears that there is no requirement at present that requires stakeholders to check surrender and work towards reduction of surrender of policies (especially on account of misselling).

[368] IRDA Circular on Benefit Illustration in Advertisement of Life Insurance Products, 23 November 2015, at https://www.irdai.gov.in/ADMINCMS/cms/Uploadedfiles/Circular%20on%20benefit%20illustrations.PDF. Accessed on 18 February 2016

[369] Sumant Prashant and Renuka Sane, *Concerns about compliance with IRDAI regulations by insurance companies*, Ajay Shah Blog, 28 January 2016

[370] IRDA (Non Linked Insurance Product) Regulations, 2013 and IRDA (Linked Insurance Product) Regulations, 2013

[371] Life insurance complaints classification issued by IRDA

*Expected impact:*

Regulation to check surrender of policies due to misselling is expected to reduce surrender payouts and consumers moving away from insurance sector. This is expected to boost sales in non-participatory non linked product segment, which has been witnessing an increase in surrender ratio.

Reduction in surrender of pure risk traditional policies is expected to fulfil the regulatory objective of pushing such policies, without any regulation around expenditure by insurers. Reduction in surrender is also expected to improve the revenue projection for intermediaries and insurers in the sector, while improving insurance penetration and density. Improved revenue projections will improve valuation of the insurers and increase their attractiveness amongst investors.

However, checking surrender on account of misselling is expected to increase costs of regulation and enforcement for regulator. The cost of compliance for industry and intermediaries is also expected to increase.

Upon comparison, the benefit to economy on account of reduced surrender and misselling is expected to outweigh the related cost of regulation, enforcement and compliance.

*Alternative 3: Disallow high upfront commissions*

As discussed earlier, high upfront commissions act as barriers to entry and expansion for potential and existing investors. The break-even is delayed and so are any plans of insurers to tap the hitherto untapped markets.

Consequently, in order to ensure that market players focus on traditional pure risk segments, there is a need to increase competition and enable insurers to quickly recover costs and expand in less profitable segments like non participatory non linked policies.

*Expected impact:*

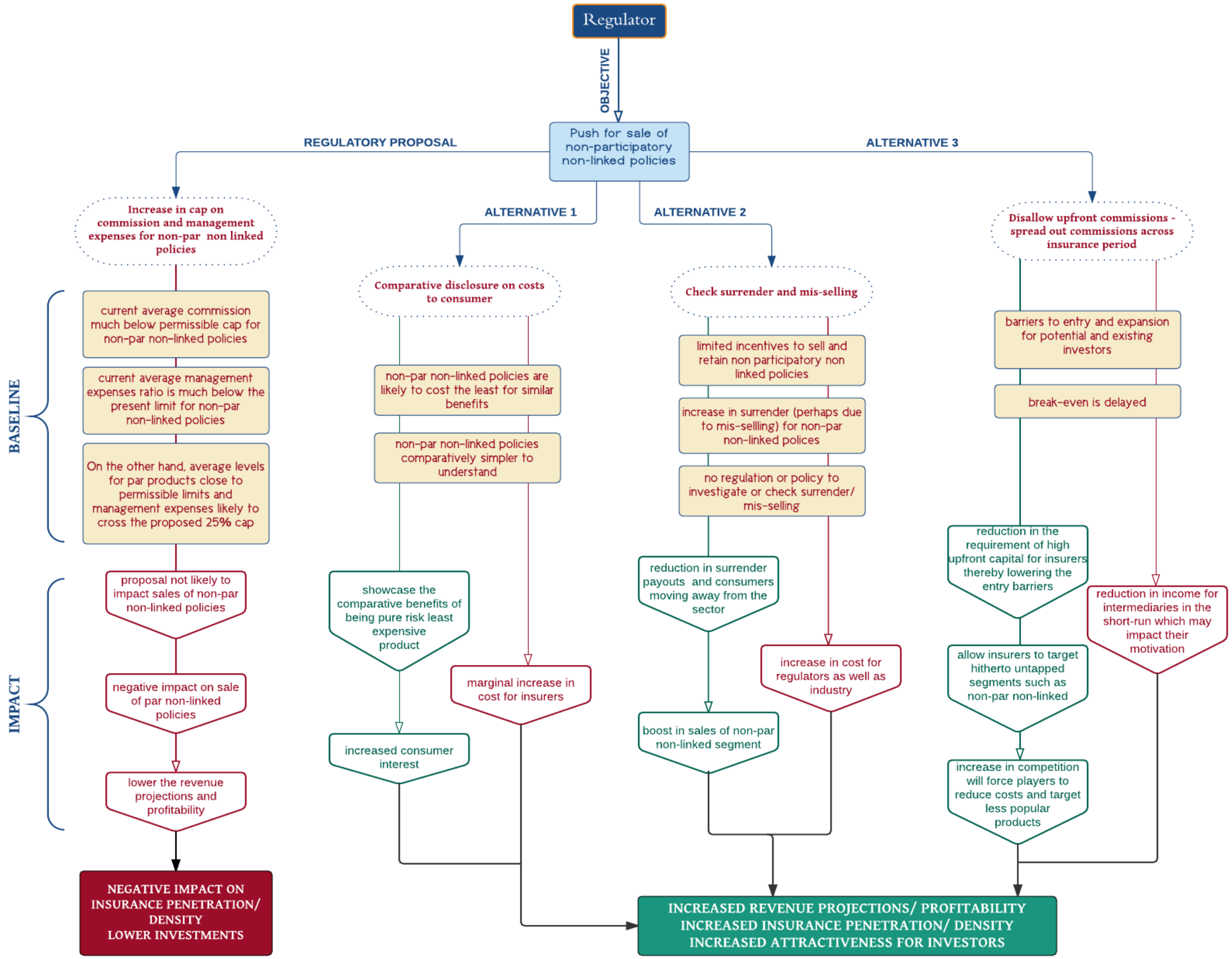
Disallowance of high upfront commissions and the requirement to spread out commissions across the insurance period is expected to reduce the requirement of upfront capital for insurers, and will allow insurers to strategically target hitherto untapped product segments, such as non participatory non linked insurance policies.

Reduction in initial costs is also expected to lower the entry barriers in the sector, and making the sector attractive for potential insurers. Increase in competition is expected to force market players to reduce the costs of operations and target less crowded product segments like pure risk insurance products.

However, disallowance of high upfront commissions is expected to reduce the income through customer on-boarding for intermediaries and they might not remain highly motivated to acquire new customers. This negative consequence is expected to be set off by increase in competition and greater demand for intermediaries by insurers, however, in long term.

Upon comparison, the costs of reduced upfront commission are expected to be outweighed by its benefits to the economy.

**Figure5. 1 - Assessment of Alternatives: Expenditure by Insurance Companies**



## Retention of customers

As discussed earlier, insurers are required to regularly report persistency and conservation levels but there is no requirement to maintain minimum persistency. The persistency and conservation levels in Indian insurance sector are abysmally low, when compared with rest of the world average. Low persistency levels adversely impact growth potential of insurers and do not make them attractive for insurers. As a result, there is a need to improve persistency and conservation levels in the industry.

*Alternative 1: Commission claw-backs*

Literature suggests that low persistency and conservation levels are on account of misselling of policies. As soon as consumers realise that the policies has been mis-sold, they stop paying premium, which results in high persistency. This tendency is increasingly being noticed amongst non-participatory non linked policies.

In order to address the problem of low persistency rates, the regulator could prescribe for commission claw backs. Claw backs allow for upfront commissions to be recouped from the agent in case the consumer exits partially or fully from the product before a predefined tenure, and has been implemented in the mutual fund market by the securities market regulator, Securities and Exchange Board of India (SEBI).[372]

Claw backs are proposed to be introduced by financial sector regulators in other jurisdictions as well, like Australia[373] and UK.[374]

Claw-backs of variable pay of directors and key managerial personnel can be witnessed increasingly in financial sector globally, and has been recommended for India as well.[375] Further, literature suggests that IRDA had proposed claw backs of commission earlier.[376]

[372] Report of the Sumit Bose Committee, 2015

[373] *ASIC to handle commission and clawback legislation,* 11 November 2015, at http://www.lifehealthinsurancenews.com.au/regulatory-government/asic-to-handle-commission-and-clawback-legislation, accessed on 15 February 2016, notes, "*The Australian Securities and Investments Commission (ASIC) will have the final word on how commissions and the clawback proposal under the Life Insurance Framework are legislated…The Federal Government will introduce legislation to Parliament later this year giving ASIC power to cap commissions and implement the clawback under an amendment to the Corporations Act.*". Also, Expsoure Draft of the Corporations Amendment (Life Insurance Remuneration Arrangments) Bill, 2015 dated 24 November 2015, at http://treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2015/Life%20Insurance%20Reform%20Legislation/Key%20Documents/PDF/Exposure%20Draft.ashx, accessed on 15 February 2016.

[374] "*Insurers are required to provide us with details of individual clawback amounts paid to intermediaries. This in turn should be reported by the intermediary as part of their return as a liability*", Financial Conduct Authority, UK, at http://www.fca.org.uk/firms/systems-reporting/gabriel/help/rma/helptexts/helptext-g, accessed pm 10 February 2016

[375] Report of the Financial Sector Legislative Reforms Commission, 2013

[376] *IRDA cracks whip on agents,* 05 March 2009, Economic Times, at http://articles.economictimes.indiatimes.com/2009-03-05/news/27654493_1_single-premium-insurance-agents-first-year-commission, accessed on 15 January 2016

*Expected impact:*

Efficiently designed claw back provisions are expected to reduce consumer churn and improve persistency and conservation of policies. The instances of misselling are expected to reduce and confidence of consumers on availing benefits of life insurance industry will increase. This is expected to increase consumer acquisition and retention. As a result, insurance penetration and density is expected to increase, and raising the revenue expectations for existing and potential insurers and consequently, the investors.

However, commission claw back provisions are expected to increase the burden on insurance intermediaries such as insurance agents and advisors. They will have to take greater care while selling the insurance policies and providing advice about the appropriate product. The consequent increase in risk for intermediaries might result in them moving away from insurance sector, which is already facing shortage of intermediaries. However, increased revenue potential of insurers might allow them to make payments to intermediaries, commensurate to their efforts in sale of insurance products.

Upon comparison, the expected benefits to the economy of designing and enforcement of commission claw-back provisions are expected to outweigh their related costs.

*Alternative 2: Enforce suitability requirements*

Consumers often drop out from insurance products because they realise that the product purchased was not suitable for them. Absence of regulations on insurers and intermediaries to assess suitability of products for the consumers often results in unsuitable advice and misselling, mostly for vulnerable retail consumers.

It has been pointed out that retail consumers may often be in a situation where they are not able to fully appreciate the features or implications of a financial product, even with full disclosure of information to them. This makes a strong case for a thorough suitability assessment of the products being sold to them. The Financial Sector Legislative Reforms Commission recommends that any person who advises a retail consumer in relation to the purchase of a financial product or service must obtain relevant information about the needs and circumstances of the consumer before making a recommendation to the consumer.[377]

The Sumit Bose Committee also recommends suitability requirements and notes that UK and Australia have moved away from a commissions based model of distribution, towards a fee-for-advice model. This has been accompanied by strong suitability requirements i.e. advisors have a duty to sell products that are suitable to customer requirements, making it imperative for them to understand customers situation and act in the interest of the customer.[378]

*Expected impact:*

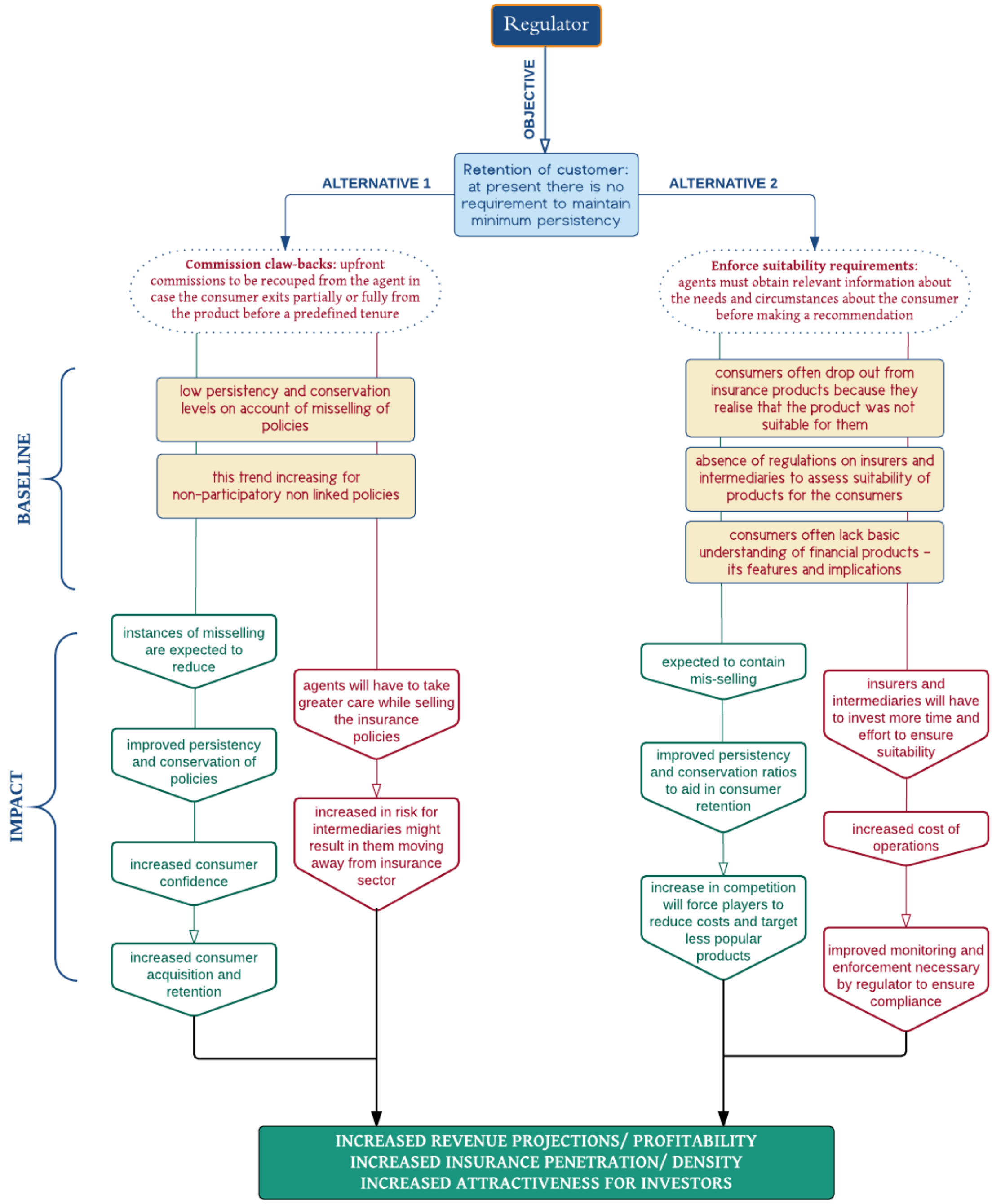
Enforcement of suitability requirements is expected to contain misselling, consequently improving persistency and conservation ratios and aid in customer retention. Improved customer retention is expected to improve revenue projects of insurers, further insurance penetration and density and make the sector attractive for insurers.

[377] Report of the Financial Sector Legislative Reforms Commission (2013)
[378] Report of Sumit Bose Committee (2015)

However, the requirement to ensure suitability is expected to increase burden on insurers, intermediaries as well as regulators. While insurers and intermediaries will have to invest more time and effort to ensure suitability, thereby hiking their cost of operations, the regulator will have to improve monitoring and enforcement efforts to ensure compliance.

Upon comparison, the benefits of suitability, in terms of improved customer retention, increase in consumer penetration and density, and healthier revenue projections for insurers and intermediaries, are expected to outweigh its costs on stakeholders.

**Figure5. 2 - Assessment of Alternatives: Retention of Customers**



## Investments in insurance companies

The prevailing regulatory scenario around allowing domestic and foreign investment in insurance companies appears to be prescriptive rather than outcome driven. In process, they could increase cost of compliance and turn investors away from the sector.

*Domestic investment:*

The regulations on issuance of capital by Indian insurance companies require insurer to obtain prior approval from IRDA before approaching SEBI. While considering the application, IRDA is required to consider company's financial position, regulatory record, capital structure, objects of the issue, embedded value, record of policyholder protection etc. Most of these aspects are reviewed by the capital markets regulator, SEBI, as well, and the aforesaid requirements appear to create duplicity and loss of time for the insurer. Moreover, while granting approval, IRDA can prescribe the extent to which promoters/ shareholders could dilute their shareholding; maximum allotment possible to foreign investors; lock-in period; additional disclosures; etc.

Limited rationale is available to provide such sweeping powers to IRDA, through which it could override management's decision and SEBI regulations applicable for capital raising by companies. Also, the objective of the IRDA regulations was to open up the sector for domestic investors. However, in its present form, it is unlikely that the regulations would achieve their objective.

*Alternative:*

A single window clearance structure for regulatory approvals for capital raising could be much more efficient. SEBI, IRDA and any other regulator (such as the Competition Commission of India) should be in a position to access application and documents for public issue, have inter-se discussion, and share consolidated non-contradictory/ consistent comments with insurer. This would help the insurer to address regulatory comments in timely fashion, without unreasonably increasing the cost of compliance.

*Foreign investment:*

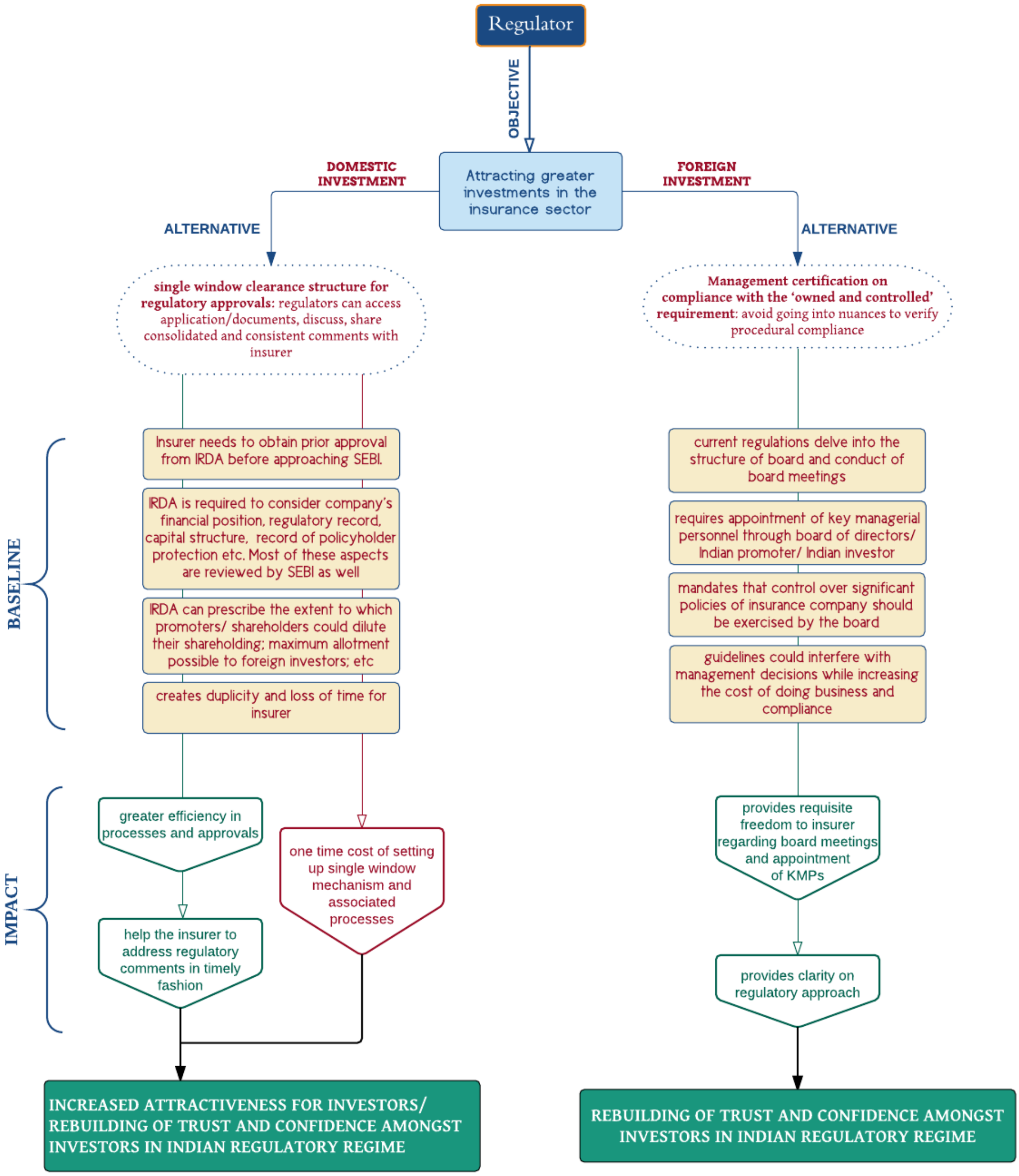
The IRDA guidelines on 'ownership and control' of Indian insurance companies do not merely rely on management certificate but delves into the structure of board and conduct of board meetings. It requires appointment of key managerial personnel through board of directors/ Indian promoter/ Indian investor. It also mandates that control over significant policies of insurance company should be exercised by the board.

While it has been argued that the detailed guidelines have been put in place to provide clarity and certainty in regulation, the guidelines could interfere with management decisions while increasing the cost of doing business and compliance. This has the potential to turn investors away.

*Alternative:*

The insurance regulator could rely on management certification on compliance with the 'owned and controlled' requirement and should avoid going into nuances to verify procedural compliance. This would provide requisite freedom to insurer regarding board meetings and appointment of KMPs. Such freedom is expected to provide clarity on regulatory approach and rebuilding of trust and confidence amongst investors in Indian regulatory regime.

**Figure5. 3 - Assessment of Alternatives: Investments in insurance companies**



## Reforming the process of regulation making

As indicated earlier, it took almost a decade to ensure passage of the Insurance (Laws) Amendment Act. Subsequent to the passage of primary legislation, several regulations have been include different bodies (Ministry of Finance and IRDA), through use of divergent regulatory instruments (regulations, guidelines, circulars). In most cases, regulations were not subject to effective public consultation[379] or regulatory impact assessment/ cost benefit analysis.[380] Moreover, several of these regulations have been amended multiple times within one year of their issuance.

Such sub-optimal regulation making changes leads to uncertain and unpredictable regulatory regime, resulting in the sector losing attractiveness for potential investors.

*Alternative:*

Efficient regulation making process has several components. These include: clarity of objective tools achieve objective, conducting of regulatory impact assessment for design a proposal potential to maximize public welfare. This is followed by effective public consultation which includes addressing stakeholder concerns. Fixing accountability of regulatory is also necessary for good regulation.

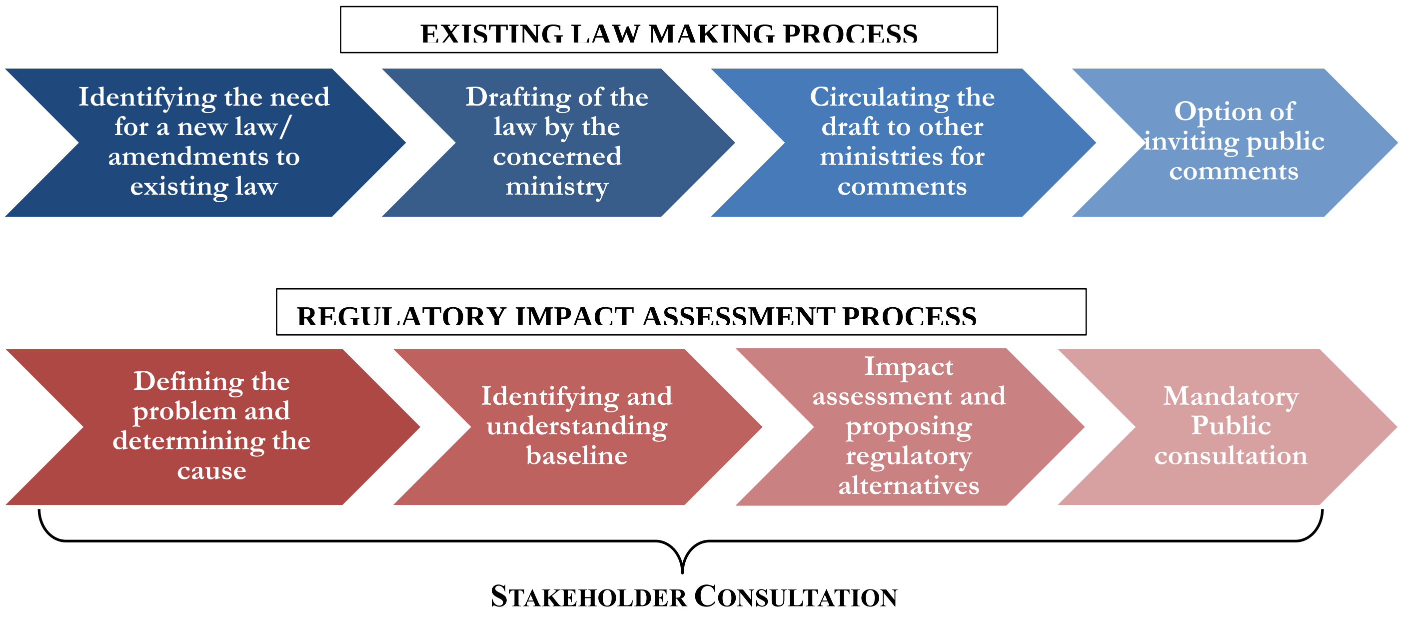
Good regulation avoids use of divergent regulatory instruments and is authorised by the board of the regulator. It is not retrospective in nature and provides adequate time to regulated entities for transition to the new regulatory regime.

Assessment of costs and benefits of possible regulatory alternatives and structured consultation is necessary for selection of such regulations, having the potential to result in maximum net benefit to the society. Reforming the regulation making process has the potential to reduce uncertainty and provide clarity in the regulatory architecture of the sector. This will increase attractiveness of the sector amongst potential investors.

[379] Principles of effective participatory governance in regulation making have been laid out in: Bhargavi Zaveri, *Participatory governance in regulation making: how to make it work*? Ajay Shah blog, 17 January 2016, at http://ajayshahblog.blogspot.in/2016/01/participatory-governance-in-regulation.html, accessed on 22 January 2016

[380] The Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code, notes that the Financial Stability and Development Council decided that financial regulators will implement non-legislative FSLRC principles relating to regulatory governance, transparency and improved operational efficiency, including cost-benefit analysis/ regulatory impact assessment of regulatory proposals.

**Figure5. 4 - Reforming the process of regulation making**



# Chapter 6
# Conclusion and Way Forward

India has a large potential market for life insurance products; however the density and insurance penetration figures remain low in comparison with the global average. There are various factors contributing to this including, low investments in the sector, inadequate infrastructure, low skills of agents, instances of mis-selling, negative perceptions about the industry in the minds of the consumer, complicated product features, unaffordable premiums among others.

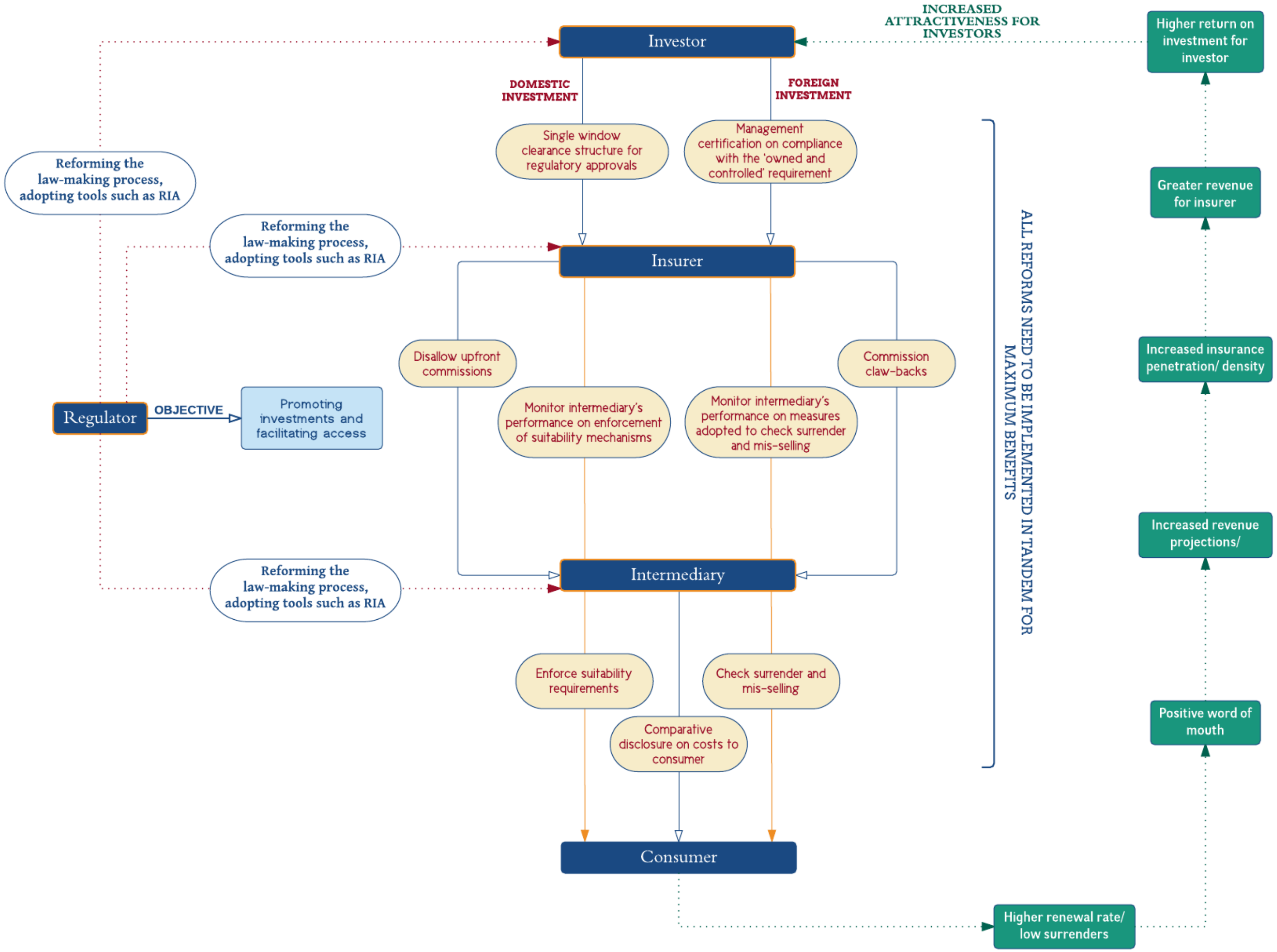
This study undertook RIA on few of the critical issues in the insurance sector including investments in the sector, expenditures by insurance companies and lastly retention of customers which has been a major challenge. As seen in the findings the regulations/ lack of regulations has resulted in a scenario of low density, high surrenders, low insurance penetration leading to low revenue for the insurer thereby low return on investment for the investor. The regulatory architecture of a nation also plays a major role in the growth of a sector as complicated structures or uncertainty can create a business unfriendly environment, thereby impacting investments. Every regulation is designed to achieve certain objectives and when the relevant regulations were analysed keeping this in mind, to understand the impact – both positive and negative, on stakeholders.

## Selection of Alternatives

The final step of RIA involves comparison and selection of alternatives that have the potential to result in the greatest benefits to stakeholders. While each regulation could have both positive as well as negative impacts, the alternative(s) selected should be one that gives the maximum net benefits. Some of the identified issues have regulations in place to achieve the desired outcomes, while others do not. For instance, persistency earlier had a regulation for maintain a certain level which was eventually revised.

In case of management expenses of insurance companies while the regulator increased the cap for non-participatory non-linked policies with the objective of pushing the sale of these products, the RIA exercise revealed that this approach would be counterproductive. On the other hand other mechanisms such as, comparative disclosure on costs to consumer, putting mechanisms in place to check mis-selling and spreading the commissions across the insurance period would be more effective in terms of benefits to stakeholders. For the issue of persistency the findings of the study show that introducing commission claw-backs and enforcing suitability requirements would result in a net positive benefit. There are various facets of an issue which need to be addressed to effectively resolve it; hence often, just one mechanism may not be able to completely address the challenges. Thus, a combination of alternatives may need to be applied rather than just one in isolation. In case of management expenses as well as persistency the findings show that implementing all the alternatives (except the regulatory alternative) together would provide the maximum net benefits to stakeholders.

## Figure6. 1 - Selection of Alternatives



## Regulatory capacity-building

The regulator has increasingly been given greater powers and authority and has put in place various mechanisms/ structures to promote the growth of the sector while at the same time ensuring consumer protection. However, in order to keep pace with the ever-changing environment, the regulator also needs to revise its process, procedures, rules and regulations to ensure they are helping meet the desired goals and objectives. Transparency, coordination between agencies/ departments, maintaining timelines are some aspects which could be improved further. Thus, it is important for the regulators to undertake periodic capacity building exercises to enhance their skills. Various challenges faced in India may also be present in other nations and learning from international best practices would ensure that regulators in India are not reinventing the wheel.

Monitoring is another important responsibility of a regulator to ensure compliance. The regulator should have the necessary skills as well as manpower to effectively monitor the market players and check critical issues such as mis-selling. In order to apply mechanisms such as suitability checks to control mis-selling, it is essential to enhance the skills of the regulator.

## Regulation making and the adoption of RIA

Regulatory instruments in India often get designed without evaluating its possible impact on stakeholders. Regulations usually have widespread impacts which affect multiple stakeholder groups in different ways. Thus, it is essential to understand these impacts while formulating any regulation so as to achieve optimal outcomes. A sub-optimal regulation can lead to higher costs of compliance, raise complexity and uncertainty associated with regulatory obligations and most importantly can limit the likelihood of achievement of intended objectives. RIA is an internationally-recognised tool which helps in designing specific and targeted policies, regulations rules etc. to achieve the desired objectives while ensuring the minimum possible burden on the stakeholders involved, resulting in maximum net benefit for society as a whole. The most important objective and benefit of RIA is its ability to help design the most effective and efficient policy design, regulatory or non-regulatory, or a mix, to ensure that the resources of the country are wisely used.

Other institutions within India have also recommended the adoption of RIA including Department of Industrial Policy and Promotion (DIPP) which emphasised the need for rigorous cost-benefit assessment of laws and regulations to help remove impediments to national growth[381]. The erstwhile Planning Commission in its report of the Working Group on Business Regulatory Environment, released in 2011[382], Tax Administration Reforms

[381] Workshop on regulatory impact assessment to cut red tape, http://www.business-standard.com/article/news-ians/workshop-on-regulatory-impact-assessment-to-cut-red-tape-115032600483_1.html, last accessed on 30 May 2015

[382] WG BRF (2011). Towards Optimal Business Regulatory Governance in India. Report of the Working Group on Business Regulatory Framework, Steering Committee on Industry, Planning Commission, Government of India. New Delhi

Commission (TARC) (Third Report: November 2014)[383] and the Financial Sector Legislative Reforms Commission[384] also suggested the application of RIA. Further, the Pre-Legislative Consultation Policy of the Government of India requires government departments to conduct partial RIA of proposed legislations[385]. An Expert Committee was recently constituted by Department of Industrial Policy and Promotion (DIPP), to examine the possibility of replacing multiple prior permissions with a pre-existing regulatory mechanism. One of the principal recommendations of the Committee is the need to develop an institutional mechanism within the government for continued and independent Regulatory Impact Assessment (RIA), of not only proposed regulations but also existing ones[386]. Thus, adoption of such a tool by IRDA would help create more effective regulations.

[383] Third Report of the TARC, http://finmin.nic.in/the_ministry/dept_revenue/TARC3rdReport.pdf, last accessed on 06 May 2015
[384] http://www.thehindubusinessline.com/opinion/columns/do-stateled-interventions-work/article7109710.ece
[385] Ibid
[386] Report of Expert Committee on Prior Permissions and Regulatory Mechanism, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, February, 2016

# Annexures

## Annexure 1: Comparison of commission and operating expenses in different product segments

The tables below compare commission payouts and operating expenses of different products segments in life insurance sector on the basis of public disclosures made by nine life insurance companies for six months period ending September 2015. This period has been chosen to take into account latest available data for conducting the primary analysis. All life insurance companies making relevant disclosures during the mentioned period have been considered.

Operating expenses comprise expenditure like employee remuneration, training expenses, rent, communication expenses, distribution expenses, sales promotion expenses, et al, for relevant product segments. Commission paid to intermediaries for relevant product segment is recorded separately, and not included in operating expenses. For purposes of the table, gross operating expenses comprise commission/ remuneration. Such gross expenses comprise substantial portion of management expenses.

**Participatory non linked policies**

| *Figures in percent* | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Comparison of par non linked policies for six months ending September 2015** | | | | | | | | |
| | **First year commission ratio** | | **Renewal commission ratio** | | **Total operating expenses ratio[387]** | | **Gross operating expenses ratio[388]** | |
| | **2015** | **2014** | **2015** | **2014** | **2015** | **2014** | **2015** | **2014** |
| Bajaj Allianz | 22.47 | 29.09 | 3.51 | 3.95 | 22.13 | 21.29 | 28.50 | 29.81 |
| Edelweiss Tokio | 24.02 | 22.68 | 4.93 | 5.10 | 73.41 | 95.44 | 83.69 | 108.96 |
| ICICI Prudential | 19.01 | 21.16 | 3.67 | 3.85 | 20.25 | 30.45 | 28.88 | 42.73 |
| DHFL Pramerica | 16.45 | 21.02 | 5.24 | 2.75 | 106.37 | 97.88 | 120.17 | 118.76 |
| HDFC Standard | 22.54 | 23.82 | 2.54 | 2.73 | 12.38 | 15.29 | 18.29 | 22.19 |
| Max Life | 34.97 | 34.94 | 5.82 | 5.49 | 18.88 | 21.87 | 30.31 | 34.22 |
| Sahara India | 23.16 | 28.25 | 4.58 | 4.94 | 26.71 | 15.32 | 32.49 | 21.60 |
| SBI Life | 19.76 | 20.83 | 4.39 | 4.86 | 14.74 | 17.25 | 24.48 | 27.92 |
| Star Union Dai-chi | 34.12 | 34.80 | 5.17 | 5.89 | 23.15 | 10.16 | 35.27 | 22.86 |
| **Average** | **24.85** | **26.57** | **4.21** | **4.29** | **17.89** | **20.76** | **26.87** | **31.05** |

[387] Ratio of Operating expenses (excluding commission) to premium
[388] Ratio of operating expenses (including commission) to premium

**Non participatory non linked policies**

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| ***Figures in percent*** | | | | | | | | |
| **Comparison of non par non linked policies for six months ending September 2015** | | | | | | | | |
| | **First year commission ratio** | | **Renewal commission ratio** | | **Total operating expenses ratio** | | **Gross operating expenses ratio** | |
| | **2015** | **2014** | **2015** | **2014** | **2015** | **2014** | **2015** | **2014** |
| Bajaj Allianz | 13.92 | 14.21 | 1.13 | 1.40 | 37.82 | 29.79 | 41.50 | 36.35 |
| Edelweiss Tokio | 17.15 | 21.19 | 4.37 | 3.17 | 151.58 | 232.28 | 163.97 | 249.10 |
| ICICI Prudential | 11.13 | -3.36 | 3.89 | 4.04 | 7.00 | 5.24 | 11.09 | 8.99 |
| DHFL Pramerica | 14.13 | 13.94 | 1.27 | 2.32 | 76.88 | 76.04 | 83.16 | 82.34 |
| HDFC Standard | 14.79 | 17.31 | 0.24 | 1.87 | 16.24 | 21.03 | 19.00 | 26.28 |
| Max Life | 25.94 | 15.98 | 2.05 | 2.88 | 19.13 | 12.38 | 29.71 | 16.17 |
| Sahara India | 10.45 | 19.76 | 3.45 | 3.83 | 71.31 | 76.71 | 75.18 | 80.47 |
| SBI Life | 4.37 | 11.43 | 2.66 | 3.04 | 8.94 | 14.53 | 11.08 | 19.06 |
| Star Union Dai-chi | 0.02 | 0.25 | 0.03 | 0.01 | 12.44 | 10.01 | 12.46 | 10.14 |
| **Average** | **9.44** | **13.28** | **2.82** | **3.37** | **14.63** | **16.52** | **18.19** | **21.04** |

**Non participatory linked policies**

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| ***Figures in percent*** | | | | | | | | |
| **Comparison of non par linked policies for six months ending September 2015** | | | | | | | | |
| | **First year commission ratio** | | **Renewal commission ratio** | | **Total operating expenses ratio** | | **Gross operating expenses ratio** | |
| | **2015** | **2014** | **2015** | **2014** | **2015** | **2014** | **2015** | **2014** |
| Bajaj Allianz | 3.23 | 2.64 | 0.98 | 1.30 | 32.56 | 56.71 | 33.92 | 58.30 |
| Edelweiss Tokio | 6.85 | 6.38 | 1.41 | 1.19 | 119.10 | 117.49 | 123.44 | 121.39 |
| ICICI Prudential | 5.67 | 5.79 | 1.35 | 1.34 | 13.49 | 13.56 | 16.47 | 16.72 |
| DHFL Pramerica | 3.80 | 4.46 | 0.30 | 0.59 | 39.55 | 38.20 | 41.09 | 39.16 |
| HDFC Standard | 16.47 | 17.77 | 0.52 | 0.64 | 11.00 | 8.88 | 15.66 | 12.98 |
| Max Life | 9.68 | 9.84 | 1.87 | 1.95 | 8.35 | 12.42 | 11.67 | 16.45 |
| Sahara India | 4.59 | 3.44 | 3.40 | 3.54 | 24.10 | 28.61 | 27.20 | 31.93 |
| SBI Life | 7.66 | 6.78 | 1.45 | 1.71 | 12.11 | 11.64 | 15.59 | 14.32 |
| Star Union | 7.24 | 7.33 | 2.34 | 2.26 | 13.58 | 34.58 | 16.15 | 38.77 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Dai-chi | | | | | | | | |
| **Average** | **8.43** | **8.48** | **1.19** | **1.25** | **13.08** | **14.50** | **16.53** | **17.87** |

## Annexure 2: Persistency ratios for life insurance companies

The table below compares persistency ratios of different periods in life insurance sector on the basis of public disclosures made by 18 life insurance companies for six months period ending September 2015. This period has been chosen to take into account latest available data for conducting the primary analysis. All life insurance companies making relevant disclosures during the relevant period have been considered.

| | | | | | **Figures in percentage** |
|---|---|---|---|---|---|
| **Persistency ratios for life insurance companies for six month period ending September 2015** | | | | | |
| **Companies** | **13th month** | **25th month** | **37th month** | **49th month** | **61st month** |
| Bajaj Allianz | 48.7 | 36.8 | 29.2 | 25.8 | 8.3 |
| ICICI Pru | 75.2 | 62.7 | 55.1 | 52.8 | 17.9 |
| DHFL Pramerica | 45.15 | 28.46 | 23.54 | 24.23 | 10.46 |
| HDFC Standard | 69.47 | 59.96 | 57.38 | 58.96 | 31.99 |
| Max Life | 73 | 60 | 53 | 47 | 31 |
| Sahara India | 75.04 | 66.98 | 51.45 | 42.84 | 30.56 |
| SBI Life | 69.37 | 57.32 | 52.05 | 39.24 | 16.54 |
| Star Union Dai-chi | 47.29 | 36.38 | 28.61 | 31.44 | 17.97 |
| Reliance Life | 57.6 | 52.3 | 52.8 | 58.7 | 11.5 |
| Shriram Life | 44.6 | 29.7 | 27.3 | 31.4 | 8.7 |
| Aegon Religare | 61 | 66 | 52 | 35 | 23 |
| Aviva Life | 62 | 47 | 41 | 36 | 20 |
| PNB Met | 65.57 | 43.02 | 38.57 | 32.58 | 14.04 |
| Bharti Axa | 51.4 | 45.7 | 39.3 | 36.4 | 33 |
| Birla Sun | 59.59 | 54.15 | 49.41 | 54 | 26.91 |
| Exide Life | 62.5 | 60.2 | 58 | 49.6 | 30.9 |
| Future Generali | 35.88 | 33.63 | 29.66 | 26.82 | 10.58 |
| IDBI Federal | 57.81 | 55.71 | 47.72 | 53.84 | 55.69 |

**Annexure 3: Conservation ratios for life insurance companies**

The table below compares consistency ratios of different periods in life insurance sector on the basis of public disclosures made by 12 life insurance companies for six months period ending September 2015. This period has been chosen to take into account latest available data for conducting the primary analysis. All life insurance companies making relevant disclosures during the relevant period have been considered.

| | | | | | | *Figures in percent* |
|---|---|---|---|---|---|---|
| **Comparison of conservation ratios of life insurance companies** | | | | | | |
| | **Six months period ending September 2015** | | | **Six months period ending September 2014** | | |
| **Insurer** | **Par non linked** | **Non par non linked** | **Non par linked** | **Par non linked** | **Non par non linked** | **Non par linked** |
| Bajaj Allianz | 77.1 | 66.2 | 66.7 | 73 | 66.7 | 72.2 |
| Edelweiss Tokio | 79.54 | 69.28 | 88.98 | 63.81 | 66.15 | 86.33 |
| ICICI Pru | 88.1 | 97.6 | 85.7 | 83.7 | 87 | 83.9 |
| HDFC Standard | 89.18 | 83.56 | 80.81 | 89.92 | 85.26 | 92.24 |
| Max Life | 86 | 90 | 81 | 88 | 91 | 82 |
| Sahara India | 91.68 | 8.57 | 52.18 | 79.83 | 11.04 | 50.53 |
| SBI Life | 85.04 | 87.77 | 85.99 | 86.98 | 82.97 | 83.28 |
| Star Union Dai-chi | 82 | 57 | 69 | 64 | 71 | 68 |
| Reliance Life | 87 | 64 | 64 | 79 | 60 | 67 |
| Sriram Life | 67.3 | 5.9 | 30.5 | 60.8 | -9.77 | 27.83 |
| Aviva Life | 54 | 85 | 67 | 79 | 83 | 79 |
| Kotak Mahindra | 88.23 | 83.51 | 83.83 | 82.56 | 84.95 | 79.21 |
| **Average** | 81.26 | 66.53 | 71.30 | 77.55 | 64.94 | 72.63 |

## Annexure 4: Surrender payouts by life insurers

The table below compares surrender payouts of different periods in life insurance sector on the basis of public disclosures made by nine life insurance companies for six months period ending September 2015. This period has been chosen to take into account latest available data for conducting the primary analysis. All life insurance companies making relevant disclosures during the relevant period have been considered.

*Figures in thousands*

**Surrender payouts by life insurers for six months period**

| **Companies** | **Half year ended September 2015** | | | **Half year ended September 2014** | | |
|---|---|---|---|---|---|---|
| | **Par non linked** | **Non par non linked** | **Non par linked** | **Par non linked** | **Non par non linked** | **Non par linked** |
| Bajaj Allianz | 379127 | | 1385369 | 388817 | | 2895844 |
| Edelweiss Tokio | 1393 | 1315 | | | | |
| ICICI Pru | 1038929 | 184848 | 14491251 | 461286 | 185006 | 25297100 |
| DHFL Pramerica | | 120194 | 173631 | | 7560 | 132088 |
| Max Life | 1095255 | 123012 | 7439789 | 801692 | | 11120289 |
| Sahara | 198128 | 2985 | 264371 | 9760 | 3367 | 845602 |
| SBI Life | 229593 | 1046646 | 9747687 | 1423458 | 1354785 | 17508486 |
| Star Union Dai-chi | 13569 | 70818 | 547321 | 3336 | 12069 | 674562 |
| IDBI Federal | 238 | 79893 | 1403224 | | 36812 | 1554128 |
| Total surrender payouts | 2956232 | 1629711 | 35452643 | 3088349 | 1599599 | 60028099 |
| Total payouts | 12316380 | 10821514 | 41471469 | 10271636 | 15665420 | 66673292 |