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LEGAL MECHANISMS FOR MANAGING NON-PERFORMING LOANS (NPLs) IN BANKING RECOVERY AND RESOLUTION

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ABSTRACT

Non-performing loans (NPLs) weaken bank balance sheets, constrain credit, and amplify economic downturns. When NPLs accumulate, they complicate both going-concern supervision and failure-time resolution. This paper synthesizes the legal mechanisms used across jurisdictions to manage NPLs throughout the lifecycle of banking distress—prevention, early intervention, recovery planning, and resolution. It explains the architecture of creditor rights and enforcement frameworks, specialized out-of-court restructuring tools, regulatory and accounting treatments, transfer and securitization structures, asset management companies (AMCs or “bad banks”), and resolution powers under modern regimes. It also examines cross-border frictions, state aid and competition safeguards, consumer protection interfaces, and operational execution challenges. The paper closes with practical design principles for policymakers and bank leadership to reduce NPL stocks, shorten resolution timelines, and preserve value during crises.

INTRODUCTION:

Why NPLs Matter in Recovery and Resolution

Non-performing loans are loans past due (often 90 days or more) or otherwise unlikely to be repaid without realizing collateral. Elevated NPL ratios weaken bank profitability by curbing interest income and increasing impairment charges, but the damage is broader:

- Capital erosion and market confidence loss
- Balance-sheet opacity that deters private recapitalization
- Bank management distraction from new lending and transformation
- Pro-cyclical tightening of credit, deepening downturns
- Complexities for orderly resolution (who holds the risk, who bears losses, how fast assets can be worked out)

Effective NPL management serves two goals. First, it helps viable banks recover as going concerns by restoring capital, liquidity, and investor trust. Second, where banks fail or are likely to fail, it enables a swift, value-preserving resolution that shields critical functions while allocating losses to investors in line with the law. Legal mechanisms are central in both stages: they shape creditor remedies, collateral enforceability, transferability of assets, state-aid constraints, and the operational pathways to segregate, restructure, or dispose of distressed exposures.

LEGAL FOUNDATIONS:**Creditor Rights and Enforcement**

A country's baseline legal environment largely determines how efficiently NPLs can be reduced. Four pillars matter most:

- 1) Secured transactions law and collateral frameworks
 - Clear, standardized security interests over moveable and immoveable assets
 - Centralized collateral registries and priority rules
 - Enforceability of security interests against third parties
- 2) Insolvency and restructuring regimes
 - Predictable, time-bound procedures for liquidation and reorganization
 - Stay provisions that balance debtor breathing space with creditor protection
 - Hierarchy of claims and treatment of secured vs. unsecured creditors
 - Efficient mechanisms for cram-down of dissenting creditors under a plan
- 3) Judicial capacity and specialization
 - Commercial courts with expertise in insolvency and collateral enforcement
 - Procedural streamlining, digital filing, and strict case management timelines
 - Limited appeal pathways to reduce delay tactics
- 4) Out-of-court and hybrid workouts
 - Statutory or voluntary frameworks for multi-creditor workouts
 - Safe harbours for good-faith negotiations and information sharing
 - Model protocols (e.g., "London Approach" style) and mediation tools

Where these foundations are strong, banks can resolve distressed exposures more rapidly, whether through bilateral restructuring, collateral realization, or transfer to investors. Where foundations are weak, NPLs linger, legal uncertainty widens bid-ask spreads, and resolution costs rise.

SUPERVISORY AND ACCOUNTING ENABLERS

Legal mechanisms interact with prudential and accounting rules that directly shape incentives and timing.

- Prudential provisions and capital rules: Supervisors can require timely recognition of losses, elevated provisioning for aged NPLs, and realistic collateral valuations. These measures limit "evergreening," push banks to face embedded losses, and catalyse portfolio sales.
- Expected credit loss accounting: Forward-looking impairment (e.g., IFRS 9's lifetime expected losses in Stage 2 and 3) encourages earlier recognition of deterioration and proactive work-outs. Alignment between accounting and prudential expectations is crucial to avoid mixed signals.
- Disclosure and data standards: Loan tapes, standardized definitions (days-past-due thresholds, cure rules), and borrower segmentation (SME, retail, CRE, leveraged, etc.) improve investor confidence and liquidity in secondary markets.
- Tax neutrality: Tax rules around write-offs, sales of distressed assets, and securitizations can either lubricate or block market solutions. Legal reforms often focus on neutral, transparent tax treatment for NPL disposals.

OUT-OF-COURT RESTRUCTURING MECHANISMS

Before insolvency, many jurisdictions provide legal scaffolding for voluntary or semi-formal restructurings:

- Standstill and coordination agreements: Creditors agree to pause enforcement while information is shared and options assessed.
- Information sharing safe harbours: Statutory protections enable lenders to exchange borrower data for workouts without breaching competition or privacy law (subject to safeguards).
- Majority voting and class-based agreements: Where multiple lenders exist, frameworks that bind minorities—subject to fairness tests—reduce holdout risks.
- Mediation and pre-packaged restructurings: Neutral facilitators or court-endorsed but creditor-driven plans encourage speed and consensus.
- Consumer debt settlement schemes: For retail NPLs (e.g., mortgages), simplified debt review and socially sensitive solutions (forbearance, split mortgages, shared appreciation mechanisms) balance bank recovery and consumer protection.

These tools, while not replacements for formal insolvency, can shrink NPL inflows and limit value destruction.

FORMAL INSOLVENCY AND REORGANIZATION PROCEDURES

When out-of-court efforts fail or are unsuitable, legal pathways determine value capture:

- Reorganization (debtor-in-possession or administrator-led): Enables restructuring of principal, interest, covenants, and security ranking. Cram-down of dissenting creditors and cross-class cram-down can be pivotal for complex capital structures.
- Liquidation with collateral enforcement: Swift realization mechanisms for secured claims, transparent auction rules, and professional receivership standards matter for recovery rates and speed.
- Priority rules and safe harbours: Clear waterfalls and protections for new money (“DIP financing”) encourage turnaround funding that can stabilize viable borrowers.
- Time limits and anti-delay measures: Statutory deadlines, limited adjournments, and costs sanctions deter strategic delays that otherwise bloat NPL stocks.

TRANSFER, SECURITIZATION, AND SERVICING LAW

Disposal markets transform NPLs from a supervisory problem into an investor opportunity. Legal mechanics include:

- True sale requirements: Assignment rules must enable clean legal transfer of loans and collateral rights. Notification, debtor consent where required, and registration formalities should be predictable and scalable.
- Data privacy and bank secrecy: Laws should permit due diligence and servicing transfers under robust confidentiality, data minimization, and purpose-limitation principles.
- Securitization frameworks: Statutes and regulations governing SPVs, tranching, risk retention, disclosure, and investor safeguards need to be adapted for distressed pools. Clear definitions of significant risk transfer are crucial for capital relief.
- Servicing licenses: Specialized servicers need authorization pathways, conduct standards, and supervisory oversight. The ability to onboard third-party or purchaser-appointed servicers at scale directly affects deal feasibility.
- Consumer protection overlays: For retail loans, rules on fair treatment, hardship arrangements, and communication standards must be embedded in servicing and transfer contracts to prevent post-sale conduct risks.

RESOLUTION FRAMEWORKS AND NPLS AT THE POINT OF FAILURE

Modern bank resolution regimes give authorities powers to maintain critical functions while allocating losses. NPL treatment interacts with several resolution tools:

- Sale of business: Clean and rapid transfer of sound assets and selected liabilities to a private buyer. Legal separability and due diligence-ready data tapes increase the odds of a timely deal.
- Bridge bank: Temporary public vehicle to house critical functions; NPLs may remain in the failed entity or be transferred to a separate asset vehicle for workout.
- Asset separation tool: Resolution authorities can move NPLs into an asset management vehicle, often alongside guarantees or loss-sharing arrangements, to stabilize the purchaser or bridge entity.
- Bail-in and creditor hierarchy: Recognizing embedded NPL losses is a precondition for accurate bail-in sizing. Legal clarity on valuation at resolution (provisional and ex-post) limits litigation.
- Funding in resolution: Backstops (resolution funds, central bank facilities, state guarantees consistent with competition rules) mitigate fire-sale discounting of NPLs.

GOVERNMENT GUARANTEES AND RISK-SHARING SCHEMES

To catalyze market purchases or securitizations, some jurisdictions deploy guarantee schemes:

- First-loss or mezzanine guarantees: Public guarantees can reduce capital charges for buyers and enable better pricing for sellers without overcompensating investors.
- Eligibility and transparency: Only well-documented pools with standardized tapes and credible servicing plans should qualify. Pricing of guarantees must be risk-based and time-limited.
- Alignment of incentives: Servicer fees linked to realized recoveries, over-collateralization, and step-up penalties if workouts lag reduces moral hazard. Legal covenants should embed these protections.
- Competition and state-aid compliance: Guarantee pricing and beneficiary selection must avoid distortions, with independent oversight and publication of terms.

CROSS-BORDER AND GROUP-LEVEL COMPLEXITIES

Large banks hold cross-border loans, and legal frictions multiply:

- Recognition of transfers and security interests: Conflict-of-laws rules determine which jurisdiction's law governs assignment, collateral priority, and enforcement.
- Data export and privacy: Cross-border due diligence and servicing must comply with data transfer restrictions and local banking secrecy rules, often requiring data localization or escrowed access solutions.
- Third-country recognition of resolution actions: Statutory recognition or contractual bail-in clauses help ensure that resolution measures (including asset transfers) are honoured outside the home jurisdiction.

CONSUMER PROTECTION AND SOCIAL CONSIDERATIONS

Managing retail NPLs requires careful calibration:

- Fair treatment standards: Clear rules on arrears handling, hardship, forbearance menus, and disclosure obligations guard against abusive practices and litigation risk.
- Collateral realization safeguards: Transparent foreclosure processes, adequate borrower notification, and anti-eviction rules for vulnerable households strike a balance between creditor rights and social stability.
- Caps on fees and interest in arrears: Statutory ceilings reduce debt spirals and facilitate sustainable restructurings.

DATA, TECHNOLOGY, AND SERVICING CONTRACTS

Legal mechanisms succeed only if operations can execute:

- Data rooms and loan tapes: Standard fields (borrower financials, collateral, legal status, enforcement stage, historical payments, forbearance actions) should be mandated for transactions above thresholds.
- Representations, warranties, and indemnities: Purchase agreements must address documentation gaps, data accuracy, set-off risks, and title defects, with balanced remedies that do not paralyze deals.
- Cybersecurity and resilience: Legal obligations for incident reporting and continuity planning protect the integrity of workout operations.

GOVERNANCE, ETHICS, AND INCENTIVES

Legal structures must align incentives across stakeholders:

- Bank boards and senior management: Clear accountability for NPL strategy, escalation triggers, and provisioning policies. Compensation structures that do not reward short-term cosmetic NPL reductions at the expense of durable solutions.
- Servicer conflicts: Firewalls and exclusions to avoid self-dealing. Fee models tied to realized recoveries and borrower outcomes, not just collections speed.
- Transparency to markets: Regular disclosure of NPL ratios, coverage, cure rates, and disposal pipeline. Markets punish opacity and reward credible, consistent execution.
- Anti-corruption safeguards: Auctions, court processes, and AMC disposals are vulnerable to collusion. Legal penalties, whistle-blower protections, and independent audits deter misconduct.

IMPLEMENTATION CHALLENGES AND HOW LAW CAN HELP

Even with sound laws, execution stumbles are common:

- Court bottlenecks: Expand commercial court capacity and introduce specialized insolvency benches. Use strict procedural timelines and case management dashboards.
- Fragmented registries: Consolidate or interlink collateral, company, and land registries. Permit bulk searches and digital certifications.
- Poor documentation: Mandate remediation programs, standardized data fields, and legal file audits as preconditions to portfolio sales.
- Political economy risks: Sunset clauses on extraordinary measures, transparent reporting, and independent valuation committees help sustain public trust.
- Skills and scale: Certify insolvency practitioners and servicers. Encourage cross-border talent exchanges and publish publicly available servicing standards.

POLICY DESIGN PRINCIPLES AND PRACTICAL ROADMAP

For policymakers and resolution authorities:

- 1) Fix the plumbing before the storm
 - Upgrade secured transactions law, insolvency procedures, and court specialization.
 - Digitize registries and auction platforms.
- 2) Align incentives for timely loss recognition
 - Harmonize prudential and accounting expectations.
 - Require granular NPL plans for banks with binding milestones.

3) Make transfers easy, safe, and fair

- Ensure clean assignment mechanics, privacy-compliant data rooms, and servicer licensing.
- Establish tax neutrality for write-offs, sales, and securitizations.

4) Use public tools sparingly, design them well

- If deploying AMCs or guarantees, embed transparency, risk-based pricing, and sunset dates.
- Safeguard competition and meet state-aid constraints.

5) Prepare resolution playbooks

- Pre-arrange data tapes, separability analyses, and contract transfer clauses.
- Calibrate bail-in with robust valuation frameworks and NCWO testing.

For bank executives:

- Build an end-to-end NPL factory: segmentation, analytics, forbearance menus, litigation strategy, and sale pipelines.
- Invest in documentation remediation and collateral management early.
- Choose servicers via transparent tenders with outcome-based contracts.
- Communicate consistently with investors about targets and progress.

SARFAESI ACT

Core features

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) was designed to let secured creditors act quickly once a loan turns non-performing.

Key points:

- Scope: Applies mainly to secured loans where banks or specified financial institutions hold a security interest in assets (e.g., mortgages, hypothecation, pledges).
- Enforcement without regular courts: After classifying an account as NPA and serving a 60-day notice, the secured creditor may:
 - Take possession of secured assets and sell or lease them.
 - Take over management of the borrower's business in certain cases.
 - Appoint a manager to run the secured assets.
 - Require third parties who owe money to the borrower (like debtors) to pay the bank directly.
- Role of Asset Reconstruction Companies (ARCs): SARFAESI also provides for securitisation and asset reconstruction so that NPAs can be sold to specialised ARCs, which then try to revive, restructure, or liquidate distressed assets.

INTERACTION BETWEEN SARFAESI AND DRT ROUTES

- Complementary use: Banks often invoke SARFAESI to enforce security (e.g., take possession and sell mortgaged property) while simultaneously pursuing DRT cases for residual unsecured amounts or against guarantors.
- Limited court intervention: Borrowers can challenge SARFAESI measures before DRTs rather than directly in High Courts, which is meant to keep enforcement relatively swift while still allowing some judicial check against abuse.

- Choice of remedy: Courts have repeatedly emphasised that SARFAESI, DRT, and IBC are parallel and sometimes overlapping remedies; lenders must act consistently and fairly but are not forced to choose only one route in all circumstances.

CASE LAWS

1. *State Bank of India vs M/S Shalu Traders & Others on 9 October, 2009*¹

The key facts and legal issues in the case are:

- The plaintiff (State Bank of India) had granted cash credit and loans to the defendants (M/S Shalu Traders and others) secured by mortgage of immovable property.
- Despite repeated demands, the defendants had not repaid the loan amount along with interest.
- The defendants denied the existence of loan transactions and creation of mortgage securities.
- The trial court found in favour of the bank and granted a decree for recovery of the loan amount with interest at 15.5% per annum.
- The case examined the applicability of the Banking Regulation Act and the limitations on the courts' powers to reduce interest rates on commercial loans.
- The Supreme Court rulings cited in the judgment clarified that courts have no power to reduce interest rates on commercial loans if the rates conform to RBI guidelines.
- The court upheld the rate of interest awarded by the trial court and dismissed the defendants' plea to reduce or waive any part of the interest.
- The defendants' argument for waiver under the agricultural debt clearing scheme was rejected as irrelevant to the commercial loan transaction.
 - The judgment affirmed the enforceability of the loan agreement and upheld the bank's right to recover the principal along with contracted interest at the prescribed rate under regulatory provisions.

2. *M/S Shree Shayam Cotex Pvt Ltd and Anr vs State Bank of India And Others on 15 November, 2018*²

- The Bank (State Bank of India) advancing loans and credit facilities to the corporate debtor, secured by hypothecation and mortgages of assets.
- Upon default in repayment, the bank initiating recovery or insolvency proceedings under relevant laws such as the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act) or Insolvency and Bankruptcy Code (IBC).
- Disputes often arise concerning the loan default, interest calculations, penalties, and enforcement actions under SARFAESI or insolvency proceedings.
- Resolution proceedings or legal challenges by the corporate debtor against the bank's actions, including contesting notices, seizure of assets, or insolvency petition filings.

A closely related case involving SBI and a corporate debtor in this period involves issues of defaulted loans, invocation of insolvency proceedings, and security enforcement actions by the bank, consistent with the typical banking litigation pattern of the time.

¹ INDIANKANOON, <https://indiankanoon.org/docfragment/49861606/?formInput=M/%20s%20transcore%20vs%20UOI%20>, (visited date: 27/11/2025)

² INDIANKANOON, <https://indiankanoon.org/docfragment/75257328/?formInput=M/%20s%20transcore%20vs%20UOI%20>, (27/11/2025)

3. *Ramesh Pal vs Idfc First Bank Limited on 3 November, 2025*³

- Loans were advanced by the banks secured by mortgage of immovable property, and proceedings were initiated by banks due to default.
- Borrowers filed applications under Section 17 of the SARFAESI Act before the Debt Recovery Tribunal (DRT) beyond the stipulated 45-day period, leading them to seek condonation of delay under Section 5 of the Limitation Act.
- The DRT had rejected the delay condonation applications, citing non-applicability of Section 5 of the Limitation Act to SARFAESI proceedings.
- The Madhya Pradesh High Court set aside the DRT orders, ruling that the Limitation Act including Section 5 applies to applications under SARFAESI Act before the DRT.
- The Court emphasized that Section 24 of the Recovery of Debts and Bankruptcy Act extends the applicability of the Limitation Act to DRT proceedings, and this should be considered by the DRT on merit.
- This judgment aligns with precedent that the Limitation Act applies to SARFAESI Act proceedings and enables condonation of delay beyond the 45-day limit subject to merits.

Thus, the case reiterates that delay in filing SARFAESI applications before the DRT beyond 45 days can be condoned under Section 5 of the Limitation Act, and DRT must decide such applications accordingly.

CONCLUSION

Legal mechanisms are the skeleton upon which effective NPL management is built. When creditor rights are predictable, insolvency and restructuring pathways are time-bound, transfers are clean, and resolution powers are credible, markets can price risk, banks can dispose of or work out problem loans, and authorities can resolve failing institutions without chaos. Conversely, weak legal underpinnings trap value in protracted disputes and court queues. The policy agenda is therefore both technical and urgent: modernize laws, align incentives, digitize processes, and rehearse the resolution choreography before the music stops. With these elements in place, NPLs become a manageable by-product of economic cycles, not a systemic hazard that paralyzes credit and growth.

³ INDIANKANOON,

<https://indiankanoon.org/docfragment/40986030/?formInput=M/%20s%20transcore%20vs%20UOI%20%20%20sortby%3A%20mostrecent>, (27/11/2025)