An Assessment of Loan Defaults and Its Impact on Profitability of Banks

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Abstract **- Banking sector plays a vital role in the growth of an economy. At present the situation of this sector is deteriorated: the rising number of NPAs in banks has become a major concern. Numerous articles show the increasing records of NPAs in the bank very frequently. Numerous researches have been conducted to dive into the status of NPAs in the bank, the reasons of this increase, the effects and many related consequences and affairs. On a macro scale, rising NPAs of banks hinder the economic growth. It affects the livelihood of all classes of people, all types of businesses and banks themselves. This Paper gives a brief introduction of the working of banks, meaning of NPA and the possible reasons for the rise in NPA. The main purpose of our study is to discuss the major effects of high number of NPAs on the bank itself. We have briefly discussed each possible effect. Our research constitutes of secondary data. There is data to show the present scenario of NPA in India. We analyzed various research papers and statistics and came up with major effects of NPAs on banks. The findings of our research came such that the effects of NPAs on banks are decrease in the profitability of bank, decrease in the overall credit rating of the bank, reduction in bank's lending potential and increase in the cost of funds. Each effect is elaborated with the help of other research studies. The conclusion of the paper gives a summary of the implications of NPAs and the steps and measures banks could take to come out of this situation.**

Index Terms **- Non-Performing Assets (NPA), Banks, Profitability, Credit, Public Sector Banks (PSB).**

INTRODUCTION

In a world where people receive education, work hard and push themselves to earn money, handling the money becomes an important task. Banks help us regulate this money. A bank is a financial institution that accepts deposits from the public and creates a demand deposit while simultaneously making loans. When we look at the bigger picture, banks help drive the economy of a country. A banking system is a group or network of institutions that provide financial services for us. These institutions are responsible for operating a payment system, providing loans, taking deposits, and helping with investments. The banking system of India comprises of the central bank (Reserve bank of India – RBI), commercial banks, cooperative banks and development banks (development finance institutions). These institutions, which provide a meeting ground for the savers and the investors, form the core of India's financial sector. Through mobilization of resources and their better allocation, banks play an important role in the development process of underdeveloped countries. In India, the development in the banking sector started with the nationalization of RBI in the year 1949 which was followed by the nationalisation of the Imperial bank of India, now called State bank of India. A bank performs two major functions, accepting deposits and lending loans. The interest offered at deposits is lesser than the interest charged on loans, this is one of the methods of making profit. Commercial banks usually lend a lot of money at all times, charging different rates to different customers based on their risk profile. This also increases the risk of loan defaults. A loan default occurs when the borrower fails to pay back the loan amount with interest as per the initial agreement. Defaulting on a loan will cause a substantial and lasting drop in the debtor's credit score, as well as extremely high interest rates on any future loan. For loans secured with collateral, defaulting will likely result in the pledged asset being seized by the bank. The most popular types of consumer loans that are backed by collateral are mortgages, auto loans and secured personal loans. For unsecured debts like credit cards and student loans, the consequences of default vary in severity according to the type of loan. In the most extreme cases, debt collection agencies can garnish wages to pay back the outstanding debt. These loans defaults are categorised into 4 types namely, debt service default, technical default, sovereign default and strategic default.

What is Non-Performing Assets (NPA)?

- Funds or assets that banks provide to companies or individuals as loans are sometimes not repaid by borrowers. The delayed or non-payment of these loans are defined as non-performing assets (NPA). They are also called bad assets.
- In India, the RBI defined it such: If for a period of more than 90 days, the interest or instalment amount is overdue then that loan account can be termed a Non-Performing Asset.

Reasons for rising NPAs:

- In early 2000 and 2008, the Indian economy was in a prosperous stage. Hence then, banks, especially those in the public sector, made large amounts of loans to companies. However, due to the global economic slowdown, mining project bans, permit delays related to environmental protection affecting the power and steel industries, fluctuations in raw material prices and supply shortages, the profits of most companies have fallen. This fall in profits led the companies to delay their payments or even totally default them and this is the most important reason for the increase in non-performing assets of public sector banks.
- One of the main reasons for the increase in delinquencies is the relaxation of credit regulations, especially for corporate executives when their financial situation and credit ratings are not adequately analyzed. In addition, in the face of competition, banks sold a large number of unsecured loans attributed to the level of non-performing assets.
- The bank did not implement adequate emergency plans, especially in terms of project risk reduction. They did not consider contingencies such as the failure of natural gas projects or the failure of acquisition of lands for roads.
- PSBs were very lenient to the defaulting corporate. They kept giving chances of restructuring of credit lines to companies with major problems such as excessive leverage and insufficient profitability.
- Unexpected economic shocks like Demonetization and Covid 19.

("NPA issue in India: Complete analysis – Civilsdaily", 2020)

REVIEW OF LITERATURE

After analysing critically, it has been observed that most of the NPAs is from several major industrialists. Mostly, the NPA for agriculture and priority sectors is relatively lower than for corporate housing. It is said that the reason for the increase in burden of NPAs for all PSBs is due to the government's policy of exempting agricultural loans in the event of floods, droughts and natural disasters. Surveys conducted by different agencies have proved that farmers and small entrepreneurs who are generally marginalized pay back their loans on time. According to the government-enacted the SARFAESI Law in 2002, banks are authorized to obtain mortgaged land and buildings. They are also allowed to dispose off by auction to recover non-performing loans. But banks still face problems in implementing the law. (Sikdar, 2020)

In December 2020, The RBI’s Financial Stability Report (FSR) has mentioned that banks’ gross non-performing assets (GNPAs) may increase to 13.5% by September 2021, and then climb to 14.8%, (almost double the 7.5 % at the same time of 2019-20), due to bad economic stress times. (Lele & Mohan, 2021)

Credit risk is the possibility that the bank borrower may default on the debt due to non-payment of the required amount in accordance with the agreed clause and the lender may lose the loan principal or interest. Profitability refers to the bank's ability to take risks and / or increase capital. It represents the efficiency of 4,444 banks and quantifies the quality of their management. According to data from the Reserve Bank of India, the total NPA of in March 2016 increased to 7.6, compared to 5.1 for in September 2015 and 4.6 in March 2015. The Reserve Bank of India forecast shows that by March 2017, the total NPA may increase to 8.5%. The increase in delinquencies is due to the increase in credit risk, which affects bank profits. Among the various risks that banks face (credit risk, operational risk, reputation risk, market risk, legal risk), credit risk is the most significant risk faced by banks, and credit is considered one of the top sources of income for the bank. The State Bank of India is the largest public sector bank in India. The research aims to find out if the credit risk faced by State Bank of India will affect the bank's profitability for more than two decades. (Sheeba. J, 2017)

The main objective of the research is to investigate whether there is a relationship between European credit risk management and the profitability of commercial banks. It also targets to investigate whether this relationship is stable or fluctuating. In the research model, ROE and ROA are defined as profitability agents, while NPLR and CAR are defined as agents for credit risk management. The study collected data from all 47, commercial banks in Europe from 2007 to 2012 formulated four hypotheses related to the research question. A series of statistical tests were performed in order to see if the relationship exists. Other statistical tests were performed to see if the ratio is stable at. The results of the survey show that credit risk management has had a positive impact on the profitability of commercial banks. Among the two proxy variables for credit risk management, NPLR has a significant effect on both ROE and ROA, while CAR has a negligible effect on both ROE and ROA. However, from 2007 to 2012, relationships between all agents were not stable, but fluctuating. (Li & Zou, 2014)

This research aims to study commercial bank loans and customer defaults and their impact on the profitability of commercial banks. The study also shows if there is a significant relationship between the amount of deposits and the level of loans and advances made to clients. It also shows if the cost of capital has a significant impact on loan delinquency. Finally, the research shows if mere collateral can be used to control loan defaults. The results obtained from the collected data show that there is a significant relationship between the amount of deposits and the level of loan advances issued to clients, and that the cost of capital has a significant impact on loan delinquency. It is necessary to draw a conclusion based on the fact that most banks have closed operations, mainly due to their mismanagement of funds. Additionally, most banks should establish credit departments as much as possible to help screen and monitor customers, which will help reduce the occurrence of mismanagement of funds and fraud. Therefore, there is evidence needed to show that, for successful and meaningful loan management, banks must strive to hire competent and honest staff to serve their loan department. (EDWARD, n.d.)

In India Non-performing assets are one among the most important concerns for banks. NPA is that the best indicator for the health of the industry. NPAs reflect the performances of banks. NPAs are the first indicators of credit risk. NPAs are an inevitable burden on the banking industry. Hence the success of a bank depends upon methods of managing NPAs. The Public Sector Banks have shown excellent performance over the private sector banks as far because the financial operations are concerned. the general public Sector Banks have also shown comparatively good result. However, the sole problem of the general public Sector Banks now-a-days are facing the increasing level of the non performing assets. The non performing assets of the general public Sector Banks are increasing regularly year by year. On the contrary, the non performing assets of personal sector banks are decreasing regularly year by year except some years. Generally reduction in NPAs shows that banks have strengthened their credit appraisal processes over the years and increased in NPAs shows the requirement of provisions, which bring down the profitability of banks. The Indian banking sector is facing a heavy problem of NPA. The magnitude of NPA is relatively higher publically sectors banks than private sector banks. To enhance the efficiency and profitability of banks the NPA must be reduced and controlled. (SINGH, 2013)

Loan deficiency takes place once an individual fails to pay back a debt in following associate degree initial arrangement. This means the recipient lost his instalment payment that should be paid on monthly bases. Generally lenders and also the bank sometimes permit some grace amount before penalizing the recipient when the non-payment of the primary instalment the interval between giving the instalment and obtaining the loan default is thought as a delinquency. Banks perform a awfully important role within the process and development. this study purpose is to acknowledge the supply of loan default on the functioning of the bank and also the live have to be compelled to want bring down the cases of loan default. to review the impact of loan deficiency on the profitableness of the bank and to direct ways that to minimize loan defaults. Information collected for the study is based on secondary statistics like journals, internet, newspaper, magazines & books. (Malik, 2021)

It explores an empirical approach to the analysis of economic banks' nonperforming loans (NPLs) within the Indian context. The empirical analysis evaluates on however banks' non-performing loans square measure influenced by 3 major sets of economic and money factors, i.e., terms of credit, bank size elicited risk preferences and political economy shocks. The empirical results from panel regression models recommend that terms of credit variables have significant result on the banks' non-performing loans within the presence of bank size elicited risk preferences and political economy shocks. Moreover, various measures of bank size may give rise to differential impact on bank's non-performing loans. In relation to terms of credit variables, changes within the value of credit in terms of expectation of upper rate induce rise in NPAs. On the opposite hand, factors like horizon of maturity of credit, higher credit culture, favourable political economy and business conditions result in lowering of NPAs. trade cycle may have differential implications statement to differential response of borrowers and lenders. (Ranjan & Dhal, 2021)

After the financial shutdown and liquidity crisis, the impact of the current Covid19 pandemic is seriously affecting the balance sheet of India's NBFC. An important indicator of this is the continued increase in the number of stressed assets. During October to December, the number of such assets increased for most of the major NBFCs in India. The rise in the number of delinquent loans means that it is detrimental to the US $ 350 billion NBFC and the entire Indian economy. If the creditworthiness of the NBFC is reduced due to the flood of bad loans, consumption or demand may weaken further. (Mulye, 2021)

This Research is a preliminary investigation of quarterly information on intentional defaulters discovered by the Credit Information of Bureau of India Limited (CIBIL) from June 2003 to March 2016. A large number of deliberate defaulters are private and unlisted restricted organizations, mainly funded by the government-owned banks. There is a view that borrowers use fragile administrative structures (such as inefficient working of national financial, legal, and political organizations) to become deliberate defaulters. This experimental study supports the hypothesis that intentional credit default is mainly caused by weak administration at the national level. (M & N, 2021)

The amount of Non-Performing Assets (NPA) best reflects the suitability of a country's banking industry. The purpose of this research is to investigate the bank's commitment to the NPA business by studying its growth pattern during 2010-2017. Furthermore, the study also investigated the influence of various banking associations, especially the State Bank of India (SBI) and its partners, state banks and private banks on their conduct of financial operations. Research shows that, compared to private banks, SBI and their associates, the growth rate of non-performing assets of private banks is higher. The study found that the failure of state banks, the SBI, and its associates to effectively handle delinquent loans is the reason for the increase in the number of such loans. (Agarwala & Agarwala, 2021)

RESEARCH METHODOLOGY

This paper includes qualitative interpretation of the major effects of bad loans on banks. Detailed explanation of each effect is given supported by either facts or data available.

We have used secondary data through the paper to support our topic. Major sources of our information and data include RBI website, CRISIL website, news articles and other research studies.

DATA ANALYSIS AND INTERPRETATION

India's non-performing loan ratio (%) is bad among emerging economies. In recent years, the share in Brazil has increased, while the share in Russia, South Africa and Turkey has decreased. After the Reserve Bank of India conducted an extensive asset quality review last year, India's non-performing loan ratio increased in 2016. The review found many failed large loan accounts, leading to a significant increase in India's non-performing assets. (Radhakrishnan, 2019)

Standard & Poor's Global Ratings said that the stressed assets of Indian banks will remain at a high of 11-12% in fiscal 2022. The agency expects the ratio of bad loans and restructured assets this fiscal year to rise by 8.7% a year ago to 11.5%. (Gopakumar, 2021)

Major Indian Banks and their Gross NPAs as of Dec 2017 (Singh, 2018)

Bank Name	Gross NPA
1. State Bank of India	Rs. 2.01 trillion
2. Punjab National Bank	Rs. 552 billion
3. IDBI Bank	Rs. 445 billion
4. Bank of India	Rs.434 billion
5. Bank of Baroda	Rs. 416 billion

Present Scenario:
Composition Of NPAs Of Public Sector Banks:
As on 31st March
(Amount in crores)

Year	Priority sector Amount	Non-priority sector Amount	Public Sector Amount	Total Amount
2020	236211.76	408205.37	28516.58	644417.13
2019	197334.47	542206.53	13394.66	739541.00
2018	187511.00	708090.00	17388.00	895601.00
2017	160941.60	523790.71	15466.02	684732.31
2016	125809.00	414148.00	3482.00	539957.00
2015	96611.00	181598.49	258.92	278468.41

Source: Department of Supervision, RBI.

Major effects of bad loans on banks are:

1) Decrease in the Profitability of the Bank:

If the bank cannot repay the loan, it will become a bad debt. When depositors request withdrawals, the bank must still repay them. In this case, the bank must pay your benefit deposit amount, which will reduce the bank's overall benefit.

Loans are very risky because repayment is not always guaranteed, and most of the time depends on other factors beyond the borrower's control. Therefore, proper management of loans not only has a positive impact on the performance of the bank, but also has a positive impact on the borrower and the economy of the country as a whole. Failure to manage loans that account for the majority of bank assets may result in high levels of non-performing loans. This in turn will affect the performance of banks and the overall economy. The loan portfolio is the largest source of business evaluation and income for most commercial banks. However, some of the loans issued were bad or in default, which had a negative impact on the financial performance of commercial banks. Studies have shown that loan defaults have two main effects on commercial banks: these effects limit the bank's financial performance and credit potential.

The profitability of the bank was adversely affected by default. The provision for bad debts are directly deducted from the proceeds of effective loans. Effective, perfect, and clearly binding credit documents reduce the tendency for deliberate defaults and improve bank performance. Bank performance has a linear relationship with credit and recovery processes (Asari et al., 2011). Asari et al. (2011) Correctly believe that banks cannot benefit from defaulted loans. The study of the validity of credit documents (a means to avoid default) is directly related to the bank's performance. The loan default reserve reduces the bank's total loan portfolio and therefore affects the interest income of these assets. This is a huge cost for the bank. Research on bank financial statements shows that unsecured loans have a direct impact on the profitability of banks. This is because bad debt expenses are considered expenses in the profit and loss account, and therefore have a negative impact on the bank's profitability (Price Waterhouse Coopers, 2009).

Berger and De Young (1997) pointed out that bankrupt banks had a large proportion of bad debts before going bankrupt, and asset quality was a statistically significant predictor of bad debts. Fofack (2005) also reported that if these institutions fail to recover bad debts, banks with a large number of loan defaults on their books may go bankrupt. One possible effect of loan defaults is the return to shareholders. Dividend payment is based on the bank's performance in terms of net income. Therefore, given that loan defaults have an adverse effect on the profitability of banks; it will affect the amount of dividends that will be paid to shareholders. The impact of loan defaults on the amount of dividends paid to shareholders will also affect capital transfers, because investors will not invest in banks with large portfolios of delinquent loans.

2) Increase in cost of funds of banks:

It will bring about expanding the expense of capital as banks will presently need to keep to the side more assets for the smooth working of its tasks. To create pay and meet the costs the banks will expand the loan fees. High NPAs oftentimes give a force to the banks to bring down their interest rates on deposits subsequently bringing down the rate at which your interest in Fixed Deposits develops. In this manner, to keep up with their NPAs, interest rates on credits and advances increase. This constantly builds the expense of taking loans deterring individuals from taking out credits and accordingly diminishing the progression of cash in the market. In this manner, high expanding NPA emergency of a nation can shake its monetary financial framework and it can surely end up being an obstacle to its development.

Example: Non-performing assets (NPA) of a bank weakens the financial policy transmission and loan rate of growth, aforesaid a recent operating paper ready by the employees members of the banking company of India (RBI). The paper titled, 'Bank Capital and financial Policy Transmission in India' shows the need of bank capital regulation in India. The study finds proof on the existence of the bank capital channel of financial policy transmission for India. It afore said that there's a positive association between bank equity and credit growth. ("Non-performing assets (NPA) could be a reason for your bank's slow loan growth rate", 2020)

3) Decrease in overall credit rating of the bank:

Bank is not just a lender but it is also a borrower of money. They can borrow money from RBI or other banks or any other entity. Therefore, banks have to maintain their credit ratings in order to procure loans. We now know that bad loans not only hinder the financial growth of a bank but also worsen its existing financial position. Increasing number of NPAs obstructs recycling of its funds and also reduces a bank's ability to lend more money (which is a primary source of banks' income). This results in decrease in profits or even incurring of losses. With bank's bad financial position and a problem of liquidity at hand due to high NPAs, its ability to repay its own loans decreases and hence the credit rating of the bank can be affected. Goodwill and brand value of a bank is affected due to high number of bad loans, so not just the credit rating is affected but also the shareholders of the bank become hesitant about their investments.

Example: In August 2021, the rating agency Standard & Poor's has updated the Indian Bank outlook from "negative" to "positive" as its capital base is expected to withstand moderate pressure on asset quality over the next 24 months. Its capitalization has increased due to their recent equity financing and increased profitability. Non-performing loans reported by the bank continued to show a downward trend, as of June 2021, from a maximum of 11.4% to about 9.7% following the merger of Allahabad Bank. However, the quality of its assets is not ideal compared to its peers such as Axis Bank, ICICI Bank or the State Bank of India. He added that Indian Bank weak loans are expected to reach around 12% of total loans in FY22 and fall to about 11.5% in FY23. In this case, the consideration of NPAs of a bank while rating its credibility is seen. This shows that NPA is a very important parameter while determining the profitability and credibility of a bank. (Lele, 2021)

4) Reduction in Bank's lending potential:

To assess advance candidates, banks progressively use credit scoring models. The target of such models commonly is to limit default rates or the quantity of mistakenly arranged credits. In this way they neglect to consider that advances are multiperiod contracts, for which reason it is significant for banks not exclusively to know whether yet in addition when an advance will default. In this paper a bivariate tobit model with a variable editing edge and test choice impacts is assessed for the choice to give an advance or not and the endurance season of conceded advances. The model ends up being a compelling apparatus to isolate candidates with short and with long endurance times. The bank's credit arrangement measure is demonstrated to be wasteful: advances are allowed such that struggles with both default hazard minimization and endurance time boost. There is in this way no compromise between higher default hazard and better yield in the loaning strategy.

CONCLUSION

On the idea of the preceding discussion, broad observations, problems and views on the performance of banking sector, money stability of the economy, credit profitability and managing NPA'S

In retrospect, the Indian Banks have overall shown a trend of continuing smart performance and profitability despite rising interest rates, increase in operational prices and also the consequence effects of recent international money crisis. This is often mirrored in higher credit growth deposit record, higher come back on assets, and return on equities. (ROE)

The capital position improved considerably because the banks were able to mobilize substantial funds.

As the analysis shown in the extent of NPAs is high with all banks presently and also the major effects of bad loan on banks are due to decrease within the profitability of the bank, increase in value of funds and reduce in bank's loaning potential. But banks are expected to bring down their NPA, this could be achieved by good credit appraisal procedures, effective control systems in conjunction with their efforts to boost quality in their balance sheets. Reduction of NPA'S will be created through RBI provisioning and write off norms.

However, maintaining profitability may be a challenge to industrial banks particularly during an extremely competitive era and gap from banking business to NBFC and foreign banks generally. This assumes significance during an amount of rising interest rates and operational prices of borrowers generally.

Banks could build efforts to mobilize funds so as to adjust to provisioning norms. However, the Capital needs would be massive. Considering the numerous structure of banks and money establishments operational within the economy and their NPA levels. The capital market setting presently prevailing within the economy would cause issues for the capital mobilization by the banks.

Finally, it's important to notice that new and personal sector banks led by SBI, HDFC, ICICI with their high capital adequacy ratios, increased proportion of common equity and higher IT and alternative trendy money skills of the personnel, are well placed to adjust to norms generally. PSU banks though dominant banks within the Indian economic system could take longer and face challenges in following the rules within the succeeding years.

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