An Analysis of Loan Defaults and Their Effect on Bank Profitability

*Dr. Manish Shrivastava

Abstract:

The banking sector is vital to the growth of every economy. The situation in this sector is growing worse at the moment, with a rise in non-performing assets (NPAs) in banks raising serious concerns. Regular articles draw attention to the bank's increasing non-performing asset records.

Numerous studies have been conducted to look at the bank's non-performing asset (NPA) status, the reasons behind the increase, the implications, and a host of other related problems and outcomes. The rise in bank non-performing assets (NPAs) is impeding economic development on a macroeconomic level. It affects all social levels, all types of businesses, and banks directly. This article gives a brief introduction to banks, explains what nonperforming assets (NPA) are, and discusses possible reasons for the recent increase in NPA due to an increase in financing costs. Each impact is expounded upon using data from further research papers. In the paper's conclusion, the effects of non-performing assets (NPAs) are briefly discussed, along with the steps and approaches banks might take to address this problem.

Keywords: Public sector banks, credit, profitability, and non-performing assets (NPA)

I. INTRODUCTION

A banking system is an arrangement of institutions or a network of them that provides us with financial services. These companies are in charge of overseeing an exchange, making loans, taking deposits, and offering financial advice. Commercial, cooperative, and development banks (sometimes referred to as development finance institutions) are affiliated with the Reserve Bank of India (RBI), which functions as the nation's central bank.Because they function as a centre for savers and investors, these institutions support India's financial sector. Because they enable resource mobilisation and more efficient allocation, banks are essential to the development of poor countries. The commencement of India's banking sector's expansion was signalled by the nationalisation of the RBI in 1949 and the Imperial Bank of India, which is now known as the State Bank of India, in 1950. Lending money and accepting deposits are a bank's two primary business activities.Offering deposits at a lower interest rate than you would for loans is one method to benefit from this. Large quantities of money are usually lent by commercial banks at different rates to a range of customers based on their risk tolerance. Additionally, this increases the likelihood of debt defaults. A loan default occurs when a borrower fails to repay the loan balance plus interest as stipulated in the original agreement.

A debtor's credit score will significantly and permanently drop as a consequence of defaulting on a loan, in addition to very high interest rates on any following loans.Upon failure on a collateralized

loan, the bank will often seize the pledged asset.

Collateral-backed consumer loans most often come in the form of mortgages, auto loans, and secured personal loans. Depending on the kind of loan, defaulting on unsecured debt—such as credit card and student loan debt—has varying degrees of consequences. In the worst case scenario, debt collection agencies may garnish wages to satisfy outstanding debt. These loan defaults are categorised into four groups: debt service default, technical default, sovereign default, and strategic default.

What Are Non-Performing Assets (NPA)?

• Assets or money that banks lend to people or companies; sometimes, borrowers don't pay back these loans. Loans that are not returned in whole or on schedule are known as nonperforming assets, or NPAs. They are also known as bad assets.

A loan account may be categorised as a non-performing asset in India, following the RBI's definition, if the interest or installment payment is past due for a period of time more than ninety days.

Reasons for the rise of non-performing assets (NPAs): 1. The Indian economy was booming in the early years of 2000 and 2008. As a result, banks—especially those in the public sector—loaned firms large amounts of money. However, the global economic downturn, bans on mining projects, delays in obtaining permits for environmental protection that affect the steel and power sectors, fluctuations in raw material prices, and supply shortages have all contributed to a decrease in the majority of businesses' revenues. The incapacity of the businesses to make payments on time or at all as a consequence of this fall in profitability is the main factor contributing to the increase in non-performing assets in public sector banks.

• The relaxation of credit limitations, especially with respect to corporate leaders and their insufficient credit and financial situation analyses, is one of the main reasons for the increase in delinquencies. In addition, banks sold a lot of unsecured loans as a consequence of competition, which was a result of the quantity of nonperforming assets.

• The bank did not have enough emergency procedures in place, especially in terms of reducing project risk. They neglected to factor in possible consequences such as the failure of natural gas projects or the difficulty of obtaining land for highway construction.

The corporate defaulter was treated quite leniently by the PSBs. They persisted in providing chances for credit line modifications to companies facing significant problems, such as high levels of debt and insufficient profitability.

• Random shocks to the economy, like COVID-19 and demonetization. ("NPA issue in India: Complete analysis – Civilsdaily" , in the year 2020)

II. LITERATURE REVIEW

A thorough examination has shown that a small number of well-known businessmen are the source of the bulk of non-performing assets (NPAs). In general, priority sectors with lower NPAs than corporate housing include agriculture. The policy of the government to exclude agricultural loans during natural disasters such as floods and droughts is said to be the reason for the increasing

amount of non-performing assets (NPAs) for all PSBs. Surveys conducted by a number of organisations have shown that farmers and small business owners that are marginalised make timely loan repayments. The government established the SARFAESI Law in 2002, allowing banks to buy mortgaged real estate and buildings. Non-performing loans may also be recouped by auctioning them.Banks' application of the legislation is still problematic, but (Sikdar, 2020).

Poor economic stress periods may lead banks' gross nonperforming assets (GNPAs) to increase to 13.5% by September 2021 and then to 14.8%—nearly twice as high as they were in 2019–20—by September 2022, according to the RBI's Financial Stability Report (FSR) dated December 2020. (Ele & Mohan, 2021).

Credit risk is the possibility that the bank borrower will fail to make the required payments in accordance with the terms of the agreement, costing the lender principle and interest.Profitability is the capacity of the bank to raise money and/or take on new risks. It evaluates and illustrates the efficiency of 4,444 banks' management. According to data from the Reserve Bank of India, the total non-performing asset (NPA) increased to 7.6 in March 2016 from 5.1 in September 2015 and 4.6 in March 2015. The Reserve Bank of India projects that by March 2017, the total non-performing assets (NPA) might be as high as 8.5%. The increase in delinquencies is the result of increased credit risk, and this has an effect on bank profits. Among the several risks that banks encounter, the most prevalent one is credit risk; other risks include those related to operations, reputation, markets, and legal issues.

Banks have a lot of risk to handle, and one of their primary sources of income is credit. The State Bank of India is the largest bank in the Indian public sector. Determining if State Bank of India's exposure to credit risk would affect the bank's profitability over a period longer than 20 years is the aim of the research. Sheeba, J. (2017)

The main objective of the research is to determine if European credit risk management and commercial banks' profitability are correlated. It also aims to ascertain if this relationship is consistent or irregular. According to the research model, ROE and ROA are agents of profitability, whereas NPLR and CAR are agents for credit risk management. Between 2007 and 2012, data from 47 European commercial banks were collected for the study, and four hypotheses were generated on the topic of the investigation. Several statistical studies were conducted to verify the validity of the correlation. More statistical tests were conducted to see whether the ratio remains stable at. The survey's results show that credit risk management has increased the profitability of commercial banks. One of the two proxy variables for credit risk management, NPLR, has a significant influence on both ROE and ROA, whereas CAR has a negligible effect on both.However, from 2007 to 2012, the relationships among all of the agents changed rather than stayed the same. Li and Zou (2014)

Examining the effects of consumer defaults and commercial bank loans on commercial banks' bottom lines is the aim of this research. The research also shows whether or not there is a significant relationship between the amount of deposits made and the total amount of loans and advances that clients get. It also shows if the cost of capital has a major influence on loan delinquency. In the end, the research shows whether managing loan defaults with just collateral is possible.

The findings of the data collection showed a significant relationship between the amount of deposits and the size of loan advances given to customers. Furthermore, the incidence of loan default is highly influenced by the cost of capital. In view of the fact that most banks have closed, mostly due to inadequate money management, conclusions must be drawn. In addition, most banks should establish credit departments as soon as they can to help with customer screening and monitoring, which will help reduce the frequency of fraud and financial mismanagement.

The findings of the data collection showed a significant relationship between the amount of deposits and the size of loan advances given to customers. Furthermore, the incidence of loan default is highly influenced by the cost of capital. In view of the fact that most banks have closed, mostly due to inadequate money management, conclusions must be drawn. In addition, most banks should establish credit departments as soon as they can to help with customer screening and monitoring, which will help reduce the frequency of fraud and financial mismanagement. Therefore, evidence is needed to show that banks have to make an effort to choose competent and reliable staff members for their loan department in order to handle loans in a significant and profitable way.

Non-performing assets are a major concern for banks in India. NPA is the most accurate indicator of the status of the sector. The performance of banks may be inferred from NPAs. NPAs are the first indicators of credit risk. There will always be NPAs to deal with for the banking industry. As a result, a bank's performance is largely dependent on its NPA management techniques. Public sector banks have done better in this area than private sector banks as they are in charge of financial operations. Additionally, the public sector banks have done rather well. But the only problem that public sector banks are now having is the increasing proportion of non-performing assets. The non-performing assets held by public sector banks are increasing year over year. On the other hand, nonperforming assets in personal sector banks are decreasing yearly, with a few notable outliers. While a rise in non-performing assets (NPAs) suggests the need for provisions that lower bank profitability, a decline in NPAs usually shows that banks have improved their credit assessment processes over time.

One of the biggest problems facing the Indian banking sector is non-performing assets, or NPAs. Public sector banks have a much higher NPA than private sector banks. To increase the efficiency and profitability of banks, the NPA must be reduced and controlled.(SINGH (2013)

A person is considered to be in loan deficit when they fail to make the necessary preparations to pay back a debt. This suggests that the beneficiary did not receive the required monthly installment payment. The period of time between receiving the installment and learning about the loan default is referred to as a delinquent installment when the initial payment is not paid. Lenders and the bank would usually give the beneficiary a grace period before penalising them.Banks play a crucial role in the development and process. The purpose of this research is to determine how loan default affects a bank's capacity to function and to emphasise the need of taking steps to lower loan default rates. to evaluate the impact of a loan shortfall on the bank's profitability and to provide tactics for lowering the rate of loan defaults. Secondary statistics from publications such as books, journals, the internet, newspapers, and magazines form the basis of the study's data gathering. (Malik, 2021)

It looks at an empirical technique for examining economic banks' nonperforming loans (NPLs) in the

context of India. The three primary categories of economic and monetary factors—lending terms, bank size-induced risk preferences, and political economy shocks—that affect banks' non-performing loans are evaluated empirically. The empirical results from panel regression models indicate that terms of credit variables have a significant influence on the non-performing loans of the banks in the face of political economy shocks and bank size-evoked risk preferences. Furthermore, the non-performing loans that the bank owns may be affected differently by various bank size measures.

According to credit variables, alterations in the credit value with respect to the higher rate assumption result in a rise in non-performing assets (NPAs). However, a longer loan maturity term, a better credit culture, and favourable political and economic situations are additional factors that help to reduce non-performing assets (NPAs). Due to the different responses of lenders and borrowers, the trade cycle may have variable consequences. In 2021 (Dhal & Ranjan).

Following the banks shutdown and liquidity crisis, the ongoing Covid19 epidemic is significantly affecting the balance sheet of India's non-bank financial companies. A crucial indicator of this is the amount of stressed assets, which is constantly increasing. The amount of these assets increased for most of the top NBFCs in the nation between October and December. The rise in past-due loans has a detrimental effect on both the US$350 billion NBFC and the Indian economy as a whole. In the event that the flood of bad loans damages the NBFC's creditworthiness, demand or consumption would worsen even worse. (Mulye, 2021)

This research is a preliminary analysis of quarterly data on intentional defaulters discovered between June 2003 and March 2016 by the Credit Information Bureau of India Limited (CIBIL).

Many private, unlisted, limited businesses that deliberately default mostly get their money from government-owned banks. Some people think that borrowers take advantage of lax administrative frameworks (such the inefficient functioning of national financial, legal, and political organisations) in order to become purposeful.defaulters. This experimental investigation supports the hypothesis that deliberate credit default is mostly caused by inadequate national administration.(M & N, 2021)

The amount of non-performing assets (NPA) is the best measure of how suitable the banking sector is in a country. By examining the bank's development trajectory from 2010 to 2017, this research aims to assess the bank's degree of commitment to the non-performing asset (NPA) business. The research also examined the ways in which various banking associations, in particular the State Bank of India (SBI) and its affiliates, state banks, and private banks, influenced the financial activities carried out by these institutions. Research indicates that private banks are seeing a higher growth rate in non-performing assets compared to SBI and its affiliates. The research claims that the increase in these debts is the result of state banks, the SBI, and its affiliates' incapacity to effectively handle past-due loans. Agarwala and Agarwala in 2021

III. RESEARCH METHODOLOGY

This essay offers a qualitative analysis of the main consequences that poor loans have on banks. Every consequence is explained in detail and is backed up by relevant data or facts. Throughout the text, we have cited secondary sources to bolster our claims. The websites of the RBI and CRISIL, as

well as news stories and other research projects, are important sources of our data and information.

IV. INTERPRETATION AND ANALYSIS OF DATA

Among all rising countries, India has one of the lowest percentages of non-performing loans. The share in Brazil has lately increased, while the shares in South Africa, Russia, and Turkey have decreased. The whole asset quality assessment conducted by the Reserve Bank of India the year before led to a rise in the nation's non-performing loan ratio in 2016. The examination turned up a large number of failed loan accounts, which raised India's non-performing assets considerably. Radhakrishnan (2019)

In the next fiscal year, stressed assets held by Indian banks are expected to remain between 11 and 12 percent of total assets, according to Standard & Poor's Global Ratings. According to the agency's projections, the proportion of bad loans to restructured assets would rise from 8.7% to 11.5% in the current fiscal year. (Gopakumar, 2021)

The primary effects of poor loans on banks are as follows:

Decline in Bank Profitability:

If the bank is unable to repay a loan, it becomes a bad debt. Depositors still need to get their money back from the bank when they seek withdrawals. In this case, the bank will have to pay the amount of your benefit deposit, which will reduce the bank's overall benefit. Loans are quite dangerous since repayment is not always guaranteed and usually rely on events outside the borrower's control. Thus, in addition to increasing bank profits, efficient loan management helps both the borrower and the whole economy. High rates of non-performing loans may be the result of poorly managed loans, which account for the majority of bank assets.

This would have an effect on the performance of banks as well as the overall economy. The loan portfolio serves as the primary income stream and means of assessing a commercial bank's performance. However, a small percentage of the loans were poor quality or defaulted, which negatively impacted the financial performance of commercial banks.

Rise in bank funding costs:

Because banks will now need to put aside more assets to maintain the smooth functioning of their operations, this will lead to greater capital expenses. To make money and pay for expenditures, the banks will increase lending fees. Banks may experience pressure to reduce their deposit interest rates due to high levels of nonperforming assets (NPAs). lowering the rate of growth in your fixed deposit interest as a consequence. Thus, credit and advance interest rates increase in tandem with their non-performing assets (NPAs). As a result, borrowing becomes more expensive over time, deterring consumers from applying for credit and reducing the amount of money entering the market. This is how a nation's quickly increasing non-performing asset (NPA) crisis may shake up its financial system and eventually become a roadblock to its development.

Example: Non-performing assets (NPA) of a bank diminish the financial policy transmission and loan rate of growth, according to a recent research paper titled "Bank Capital and Financial Policy

Transmission in India" by workers of the Banking Company of India (RBI). The research concluded that there is a positive link between bank equity and credit growth ("Nonperforming assets (NPA) could be a reason for your bank's slow loan growth rate", 2020) and demonstrated the existence of the bank capital channel of financial policy transmission for India.

A reduction in the bank's total credit rating:

In addition to lending money, the bank also borrows it. They have access to loans from banks, other institutions, and the RBI. Consequently, banks need to maintain their credit ratings in order to be eligible for loans.

As of right now, we know that bad loans not only hinder a bank's capacity to develop financially, but also worsen its existing financial status. A rise in non-performing assets (NPAs) restricts the bank's ability to make new loans, which is how the bank makes most of its money. It also makes it more difficult for the bank to recycle its capital. Earnings decrease as a consequence, and losses may ensue. The bank's ability to repay its own loans is diminishing as a result of its precarious financial situation and the present liquidity problem caused by significant non-performing assets. This might potentially affect the bank's credit rating. A large proportion of bad loans has a detrimental effect on a bank's reputation and goodwill; therefore, the credit rating suffers and the bank's shareholders begin to worry about making investments.

For example, Standard & Poor's revised its August 2021 outlook for Indian Bank from "negative" to "positive" based on the assumption that the bank's capital base can withstand some effect on asset quality over the next 24 months. Their financial success may be attributed to their recent equity financing and increased capitalization. Following the merger with Allahabad Bank, the bank's stated non-performing loan percentage decreased to around 9.7% as of June 2021 from a high of 11.4%. The quality of its assets is subpar compared to that of Axis Bank, ICICI Bank, and the State Bank of India. He continued by saying that it is anticipated that bad loans from Indian banks would make up around 12% of total loans in FY22 and then fall to about 11.5% in FY23. In this case, a bank's trustworthiness is determined in part by its nonperforming assets (NPAs). This proves that NPA is an important consideration when evaluating the profitability and standing of a bank. (Lele, 2021)

Reduction in Bank's Lending Potential:

Credit scoring methods are being used by banks progressively to assess advance applicants. Usually, the goal of these models is to limit the quantity of credits that are positioned improperly or the default rates. They fail to see that advances are contracts with many periods, which is why it's critical for banks to understand if and when an advance may default. This study uses a bivariate to bit model with a variable editing edge and test choice effects to assess the decision of whether or not to give an advance and the endurance season of granted advances. Ultimately, the model shows itself to be a valuable instrument in differentiating candidates based on their endurance times. It is shown that the bank's credit arrangement measure is ineffective: advances that have difficulty decreasing default danger and lengthening endurance time are accepted. This indicates that the greater return of the lending method does not come at the expense of increased default risk.

IV. CONCLUSION

Based on the concept of the previous discussion, general observations, issues, and opinions regarding the banking sector's performance, the economy's money stability, the profitability of loans, and the management of non-performing assets. In hindsight, the Indian banks have generally demonstrated a history of sustained profitability and smart performance in spite of growing interest rates, an increase in operating costs, and the fallout from the most recent global financial crisis. stronger credit growth deposit records, stronger asset returns, and higher return on equity frequently reflect this. Due to the banks' ability to raise huge sums of money, their capital situation significantly improved. According to the report, all banks currently have a high level of non-performing assets (NPAs). The main consequences of bad loans on banks are decreased bank profitability, an increase in fund value, and a reduction in the bank's ability to lend money. However, banks must reduce their non-performing assets (NPA). They can do this by using sound credit appraisal practices, strong control mechanisms, and initiatives to improve the quality of their balance sheets. RBI write-off and provisioning rules will result in a decrease in NPAs.But industrial banks may find it difficult to be profitable, especially in this fiercely competitive period and with the shift away from the banking industry to NBFC and foreign banks in general. This is predicated on the fact that interest rates and borrower operating costs are both on the rise. In order to conform to provisioning rules, banks could increase their attempts to raise money. But the amount of Capital required would be enormous. Taking into account the many forms that banks and other financial institutions operate under in the economy, as well as their NPA percentages. The current state of the capital market in the economy would make it difficult for banks to mobilize money. Last but not least, it's critical to note that new and personal sector banks, lead by SBI, HDFC, and ICICI, are well positioned to adapt to regulations generally due to their high capital adequacy ratios, increased share of common stock, and higher IT and alternative fashionable money skills of the workforce. Despite being the leading banks in the Indian economy, PSU banks may find it more difficult and time-consuming to adhere to regulations in the years to come.

***Associate Professor**
Department of Economic
Administration and Financial Management
S.S. Jain Subodh PG College
Jaipur (Raj.)

REFERENCES

[1] Rajeev Ranjan and Sarat Chandra Dhal (2003) Research Paper on Non-performing loans and term of credit of public sector bank in India: An Empirical Assessment Vol 24, Reserve bank of India Occasional paper

[2] Pro. D.S.Rathore (2016) Research on Non-Performing assets of Indian Banking system and its impact on the economy. IOSR Journal of economic and finance Vol7, Issue 6 ver.III, ISSN: 2321-5925

[3] Sikdar, A. (2020). NPAs and its effects on banks' profitability. Retrieved 15 August 2021, from https://timesofindia.indiatimes.com/blogs/econo mic-update/npas-and-its-effects-on-banksprofitability/

[4] Li, F., & Zou, Y. (2014). The Impact of Credit Risk Management on Profitability of Commercial Banks. Retrieved 15 August 2021, from https: //www.diva-portal.org/smash/get/diva2:743402/ FULLTEXT01.pdf

[5] EDWARD, O. LOAN DEFAULT AND ITS IMPACT ON PROFITABILITY ON COMMERCIAL BANK.docx. Retrieved 15 August 2021, from https://www.academia. edu/29245846/LOAN_DEFAULT_AND_ITS_IMPACT_ON_PROFITABILITY_ON_COMME RCIAL_BANK.doc

[6] SINGH, M. (2013). PERFORMANCE OF NONPERFORMING ASSETS (NPAS) IN INDIAN COMMERCIAL BANKS. Retrieved 15 August 2021, from http://citeseerx.ist.psu.edu/view doc /download?doi=10.1.1.1056.6838&rep=rep1&ty pe=pdf

[7] Sheeba. J, J. (2017). A STUDY ON THE IMPACT OF CREDIT RISK ON THE PROFITABILITY OF STATE BANK OF INDIA (SBI). Retrieved 15 August 2021, from http://ictactjournals.in/paper/IJMS_Vol_3_Iss_2 _Paper_9_538_542.pdf

[8] Gopakumar, G. (2021). India bank's NPA to rise to 11-12% in FY22: S&P. Retrieved 15 August 2021, from https://www.livemint.com /industry /banking/india-bank-s-npa-to-rise-to-11-12-infy22-sp-11625056416141.html

[9] Lele, A. (2021). S&P upgrades outlook on Indian Bank to stable on funding, liquidity profile. Retrieved 15 August 2021, from https://www. business-standard.com/article/finance/s-pupgrades-outlook-on-indian-bank-to-stableonfunding-liquidity-profile-121080600311_1.html

[10]Singh, H. (2018). List of Public Sector Banks which have highest share in NPA. Retrieved 15 August 2021, from https://www.jagranjosh .com /general-knowledge/list-of-public-sector-bankswhich-have-highest-share-in-npa1525440048-1)

[11] Non-performing assets (NPA) could be a reason for your bank's slow loan growth rate. (2020). © March 2022| IJIRT | Volume 8 Issue 10 | ISSN: 2349-6002 IJIRT 154144 INTERNATIONAL JOURNAL OF INNOVATIVE RESEARCH IN TECHNOLOGY 202 Retrieved 15 August 2021, from https:// www.thebridgechronicle.com/business/finance/n on-performing-assets-npa-could-be-a-reason-foryour-banks-slowloan-growth-rate

[12]NPA issue in India:Complete analysis – Civilsdaily. (2020). Retrieved 15 August 2021, from https://www.civilsdaily.com/news/financecommission-and-bank-recapitalisation/

[13]Malik, R., 2021. An Impact of Loan Defaults and Impact on Profitability of Bank. [online] Ijream.org. Available at: [Accessed 15 August 2021].

[14]Ranjan, R., & Dhal, S. (2021). Non-Performing Loans and Terms of Credit of Public Sector Banks in India: An Empirical Assessment. Reserve Bank Of India Occasional Papers, Vol. 24(No. 3,). doi: 2003

[15]Mulye, P. (2021). Rising loan defaults are adding to the woes of non-bank lenders in India. Retrieved 15 August 2021, from https://scroll.in /article/989679/rising-loan-defaults-are-addingto-the-woes-of-non-bank-lenders-in-india

[16]M, J., & N, P. (2021). Wilful defaulters of Indian banks: A first cut analysis. Retrieved 15 August 2021, from https://www.sciencedirect.com/ science/article/pii/S0970389617302136

[17]Agarwala, V., & Agarwala, N. (2021). A critical review of non-performing assets in the Indian banking industry | Emerald Insight. Retrieved 15 August 2021, from https://www.emerald.com/ insight/content/doi/10.1108/RAMJ-08- 2019- 0010/full/html