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# Impact of loan defaults on bank's profitability

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**Abstract**
When the loan borrower fails to make periodical payment of interest or principal or both then such loan borrower becomes the loan defaulter. For banks, loans are such assets which generate income considered as performing assets and when such loans don't generate income become the non-performing assets. Banks want to have low NPA as much as possible so that their profitability doesn't get affected to a large extent. Bank performs a very vital role in the economic process and development of a country. The purpose of the study is to recognize the source of loan default on the functioning of the bank and what steps could be taken to lower the cases of loan defaults. To study the impact of loan defaults on banks profitability and to find out ways to lessen loan defaults. Data collected for this study is mainly based on secondary statistics such as journals, newspaper, internet, magazines & books.

**Keywords:** loan, loan default, banks, profitability

## Introduction

Failure to pay due interest or principal on a debt constitutes default. For creditors default risk is an important consideration while providing loan to borrowers. Defaulters can be an individual, business houses or even countries. Usually in case of non- payment of interest or principal amount, lenders and banks provide some grace period to the defaulters before taking any harsh action against defaulters. After completion of grace period, the defaulters are forced to liquidate their pledged asset for recovery of loan. But if no assets were pledged initially at the time of borrowing loan, then such loan is written off as bad debts. The famous largest corporate default case is Lehman brothers (Sep. 2008) case where there was a default of around $613 billion leading to global economic and financial crisis. As per RBI just 312 big defaulters owe more than 76% or Rs.1,41,583.50 crore of the total bad loans. Over the previous 10 years, willful defaulters' debt to Indian banks has increased more than ten-fold, from Rs. 23,000 crore on March 31, 2012, to Rs. 2.4 lakh crore on May 31, 2022. Banks plays a prominent role in the economic process and development. So, after 2008 global crises, new risk management methods were devised to avoid such crises in future. Defaulting on a loan payment can cause a substantial and lasting drop in the debtor's credit score and future loans will be given at very high rate of interest.

## Objectives

1. To identify the factors behind the loan default
2. To suggest some measures in order to decline loan default cases.
3. To investigate the result of loan default on bank's profitability.

## Literature Review

Evans Oteng (2017) [1], according to the study conducted on bad loans and its impact on the profitability of a bank in Ghana-European reveals that extreme rate of interest on loan is main reason behind the loan defaults. Moreover, Loan processing and its disbursement are not on time. Loan recovery should be supervised properly. For disbursement of the loan, there should be proper rules and procedure.

Chen, Zhang and Ng (2018), according to the study there some factors associated with default include: the inability to channelize funds to other borrowers; disinclination of other financial institutions to cater the requirement of small borrowers; and the creation of distrust.

Strom (2020), as per study the bank's financial performance is reduced by the loan defaults. The theory of loanable funds shows that the level of loanable funds are reduced by loan defaults which further reduces the loan amount advanced to borrowers.

Mburu, Mwangi&Muathe (2020), states that the rate of loan defaults is one of the indicators of financial sector health of an economy. Extreme level of loan defaults in an economy indicates most unsound financial sector.

Pro D.S Rathore (2016) [2], as per study titled "Non-Performing assets of the Indian banking system and its impact on economy" reveals that a positive relationship has been found between NPA's and net profit of banks due to mismanagement in bank. Banks have chosen the wrong clients due to which there is a positive relationship between profits and NPS's of Banks leading to affect the liquidity of banks adversely. Due to high NPA's there is lack of funds and therefore banks are not able to provide loans to new customers.

Bottiglioni, (2019), when the borrower doesn't pay the agreed-upon installments or interest for more than 90 days, the bank considers the loan to be in default.

Cullen, (2018) Borrowers who do not return loans in accordance with their contractual obligations are said to be in default.

Rajeev Kumar Upadhyay (2019) [3], in the study titled 'Predicting Default by Indian firm founded that the defaulting firms when compared to the non-defaulting firm, the liquidity and structural key ratios start to decline.

## Analysis

The paper's findings are based on secondary data that has been compiled from many journals, newspapers, online resources, magazines, and printed books provide a comprehensive database of loan default literature.

**Some important factors behind the loan defaults**

- Delay in Salary- The most frequent cause of loan default in India, accounting for 30% of all defaults, is salary delay. Salary delays are typical whether you work for the government or for a private company. When a borrower's income is delayed by more than a month, they are therefore left with little choice but to repay the debt.
- Job loss- As the global economy has slowed, more jobs have been lost, which leaves the borrower unable to repay the loan as it is currently due.
- Lack of motivation to repay the debt as a result of borrowers' financial mismanagement
- Loss in business- Since there are no guarantees in business, the majority of entrepreneurs need a business loan to ensure the success of their endeavor. Any failure makes it difficult to repay the debt, which ultimately results in loan default.
- Frauds- This is one of the main causes of loan default as well. You may seem it impossible, yet some people do borrow money with the deliberate aim of not paying it back. Even though it is challenging, some people are able to qualify for a loan without the necessary paperwork. Some hide themselves away so that the lender can't find them or get their money back.
- High interest rate on loans
- Absence of Monitoring
- Governments typically establish interest rate caps.
- Willful negligence

**Measures in order to decline loan default cases**

- The quality of the loan evaluation processes has to be improved by the loan officers. To prevent problems with identifying borrowers after loan disbursement, they must gather information about loan customers and monitor customer business.
- To avoid excessively delaying loan disbursement and perhaps losing out on business prospects, management should examine the loan appraisal process. For payment, the appraisal must be finished within three working days.
- Repayment of loans should be closely monitored, and the bank should act quickly whenever a customer defaults.
- To assess the borrower's credit risk and decide whether to provide a loan, a good credit analysis of the prospective customer is necessary.
- Using Real-time APIs, integrate with Credit Scoring Agencies
- Thorough background check for business loans using technology which should involve looking at their past few years' worth of income, assets, liabilities, EBITDA, and GST filing.
- Regular Reminders for payment across All Channels.

**The impact of loan default on the bank's profitability**

The amount of loanable funds will likely decrease as the ratio of bad loans rises, which will have different consequences on the bank's interest revenue, operational profit, and net profit. Loan default and cost-income ratio had a negative impact on the profitability while revenue and loan recovered had a positive impact. Liquidity was statistically insignificant. Net profit and NPA have a positive relationship, which is bad for the bank. A positive correlation between NPA and profit results from the bank's poor client selection which significantly impacts the bank's liquidity. Due to a shortage of funds, the bank does not provide loan to the new customer. More profits will result from properly managing the loans provided to borrowers, and the profitability is significantly impacted by the problem of recovery and past-due loans.

**Conclusion**

This study is being done to look at loan default and how it affects the bank's profitability. One of the key factors that have been identified as affecting the bank's profitability and existence is loan default. The significance of this study comes from the fact that the economy's ability to function effectively depends on a flourishing financial services sector. A financial system default is a sign that the economy is failing.

According to this study, the bank must obtain securities or collateral before approving an advance in order to assure that there would be no obstacles in the way of the bank realizing the security in the case of default. Proper information must be gathered by the loan officer before granting the loans in order to ensure proper management of the loans issued to borrowers, which will result in greater earnings. Banks should continuously check repayment. The loan evaluation process needs to be reviewed by management as well. Banks should do a thorough background check for business loans using technology which should involve looking at their past few years' worth of income, assets, liabilities, EBITDA, and GST filing.

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