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The Role of Willful Defaults in Bank's Profitability: An Investigative Study

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Abstract: Banks are economy progress drivers. Credit risk, interest risk, liquidity risk, market risk, operational risk and management risk are faced by banking business and are very important risk related to bank performance. Corporate lending is a prime driver of banks profitability but is also prone to more risk of lending in recessionary conditions. At times banks do also experience of willful default under exceptional circumstances. These days increasing willful defaulters is a serious problem faced by Indian banking sector which has affected financial health and capital base of Indian banks. A high level of willful defaulters proposes high probability of large numbers of credit defaults that affects the profitability, net income of banks, erosion of the value & quality of assets, survival of banks and that will be contagious to growth and performance of the economy at large.

The study aims at financial soundness and sustainability of banks particularly of those which are facing troubles and making struggles to deal with the management of large incidence of willful defaulters. This paper is basically based on literature reviewed, annual published reports of commercial banks by the Indian banks association (IBA) and various initiatives taken by different banks to recover the loan. This theoretical framework and data set examined by regression analysis to examine the outcome in a above said perspective. The early research findings highlight the importance of early resolution of willful defaulter designate NPA's to restore financial health and to ensure financial sustainability of banking operations.

Keyword: Willful defaults, Banks, NBA's, Bankruptcy, and Credit risk etc.

Introduction

The banking sector is the heart of the financial system. The major function of the financial system is the mobilization of the public savings and its allocation in different sectors of the

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economy as an investment. The conversion of financial savings into investment is known as the process of capital formation in the economy. How this process of financial intermediation (i.e. collecting scattered savings and using it in to productive purposive) is carried out shall reflect the efficiency of the financial institutions and their role in socio-economic transformation of the nation. The Narasimhan Committee (1991) recommendations develop into non-performing assets in exhaustive way. The status on non-performing assets constitutes the best indicator of judging the health of the banking industry. The problem of NPAs is linked with the lending procedure of banks as these are an inevitable burden on the banks. A bank gives out money upfront and earns income over a time on the promise of a borrower to repay. When loans are not repaid, the bank loses both its income stream, as well as its capital. Lending is always accompanied by the credit risk arising out of the borrower's default in repaying the money. The major problem today faced by all the commercial banks is the increasing risk of non-performing assets, which poses challenge to their ultimate survival.

The NPAs have been classified under four categories:

(i) **Standard Assets**: A standard asset is a performing asset. Standard assets generate continuous income and repayments as and when they fall due. Such assets carry a normal risk and are not NPAs in the real sense.

(ii) **Sub-standard Assets**: All those assets which are considered as non-performing for a period of 12 months.

(iii) **Doubtful Assets**: Those assets which are considered as non-performing for period of more than 12 months.

(iv) **Loss Assets**: All those assets which cannot be recovered.

The performance of the banking sector, Public Sector Banks (PSBs) in particular, continued to be decreasing in all the financial years. Out Of these NPAs, more than 50% are bad loans due to big corporate houses who take big loans from these banks but unable to payback these loans with big amount of interest. But there are some who defaults willfully or we can say that they have

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capacity to payback the loans but do not do so. About 10% of the big chunk of bad corporate loans defaulted in paying their loans willfully and termed as willful defaulter. RBI had instructed for collection of information on willful defaults of Rs. 25 lakhs with effect from 1st April 1999 under which the banks and notified All India Financial Institutions were required to submit to RBI the details of the willful defaulters. And these provisions amended from time to time.

Source: www.hindustantimes.com

Definition of Willful Defaulter as notified by RBI-

Willful default is a situation where-

1) An organization has the capacity to pay its debt but he did not honor their debt obligation.
2) The organization used the funds for other purpose without giving any information to the lender regarding the use of funds that are mention in the agreement.
3) The organization has sold out/ disposed off the assets which is used as a security for taking the loan without the knowledge of the lender & also did not used the funds for specific purpose.
4) The organizations has taken the loan by giving wrong information or with the help of window dressing and utilize the funds not for specified purpose & did not have any assets to repay the debt.

Objectives of the Study

1) To study the incidence and the impact of willful defaults on the profitability of banks.
2) To analyze scale of profitability in relation to the total corporate lending by the banks.

Hypotheses

H_{01} That willful default is not statistically significant in relation to the bank's profitability.

H_{02} There is no relationship between bank's amount of lending and profitability.

Literature Review

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Mishra & Pawaskar (2017) in their research paper 'A study of nonperforming assets & its impact on banking sector' found that public sector banks facing the severe problems of NPA's & their recovery as compare to private sector banks. They conclude that there must be a legal procedure for debt & NPA's recovery because they include litigation & court orders to recover the loans for the prevention of NPA's. Banks should also have better credit appraisal system also need to get support from the system. **Swain sahoo et. al. (2017)** made a study on "NPA of scheduled commercial banks in India: its regulatory frame work." The study concludes that there is a high level of NPA's in the scheduled commercial banks. The government took a lot of actions to minimize the NPA but still a lot of efforts have to be taken in this direction or to stop increasing NPA. The study also concludes that SARFEASI Act play a significant role in NPA recovery in comparison to other measures. **Mittal & suneja (2017)** made a study on "The problem of rising nonperforming assets in banking sector in India; comparative analysis of public & private sector banks." They studied the bank's NPA's level and their reasons of increasing. The study conclude that NPA of private sector banks are less as compared to public sector banks & private sector banks meet out their NPA's efficiently in comparison to public sector banks. **Goel (2016)** studied on The Insolvency and Bankruptcy Code: Problems & Challenges. The author has studied on the conceptual framework of the paper and discussed about the various problems and challenges in this bill. It concluded that though this bill is a major step taken in right direction but this code is over ambitious on one hand it is aiming at major amendments in over 11 statues and on the other hand it is aiming at institutions in the likes of the NCLT. Main problem discussed by the author is improper distribution of constitutional powers between authorities. **Kaur (2016)** studied on impact of stressed assets of banks on companies. A conceptual study has been done which explains the meaning of stressed assets, their cause and how do they impact companies borrowings. Now, Companies with more than a fixed amount of debt will have no choice but to tap bond markets for at least half their new borrowings. With this various suggestive measures has been given to decrease the level of stressed assets of various banks. **Sengupta et. al. (2016)** studied on Evolution of the insolvency framework for non-financial firms in India. In this paper author described the evolution of the corporate insolvency resolution with the objective of linking it back to the policy directive of the time. It has done a conceptual study of various insolvency reforms and concluded that when policy

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adopts a piecemeal approach focusing on solving only a part of the complex problem, one at a time it most often leads to inefficient outcomes on the overall objective & introduction of IBC Act (2016) is a good step being added in these reforms. **Kiran & jones (2016)** made a study on "Effect of nonperforming assets on the profitability of banks – A selective study." The study analyzes the effect of NPA on the profitability of public sector banks. They conclude that all other banks have a negative correlation between gross NPA & net profits but SBI earn continuous profits. **Singh (2016)** did a study of Non-Performing Assets of Commercial Banks and it's recovery in India by analyzing its conceptual framework and impact of NPAs on profitability and their various recovery channels. This study has been analyzed using simple statistical tools like percentage and bar diagrams. The author has concluded that though major steps for recovering NPAs has been taken but there is still more to stop increasing NPA's. **Garg (2016)** in the research paper "A Study on management of nonperforming assets in context of Indian banking system" discuss about the impact of NPA on the profitability of banks, preventive measures for NPA, procedures for NPA identification & compromise settlement scheme. **Laveena & Kumar (2016**) in the research paper "Management of nonperforming assets on profitability of public & private sector banks" discuss about the concept of NPA, provisioning norms, NPA' management strategies, factors which cause rise in nonperforming assets, steps have to be taken immediately when assets made default in payment, reasons & preventive measures of NPA's & conclude that banks have to strengthen their credit evaluation norms. **Rao & Patel (2015)** made a study on "A study on NPA management with reference to public sector banks & foreign banks in India" with the objective of comparison analyses & interpretation of NPA management for the year 2009-2013. Their results shows that increasing the percentage of gross NPA's to gross advances of public banks, higher the ratio of loss advances to gross advances in foreign banks & public banks estimated gross NPA's of 2014 is also more in comparison to private & foreign banks. Their findings conclude that public sector, private sector & foreign banks ratio of gross NPA to gross advances does not have significant difference between 2009 to 2013. **Sikdar & Makkad (2013)** in the research paper "Role of nonperforming assets in the risk framework of commercial banks –A study of select Indian commercial banks." The study concludes that with the proper mechanism of credit assessment & risk management, the problem of NPA can be resolved. For the proper credit worthiness, skill up gradation,

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improved managerial efficiency & organizational restructuring are necessary. **Balasubramaniam (2013)** studied on "Nonperforming assets and profitability of commercial banks in India: Assessment and emerging issues" This paper focused on the proposal issued by RBI to introduce BASEL III norms in Banking Sector from Jan 2013. It analyzed a trend analyses on the high level of borrowing from banking sector and also highlighted on certain issues and perspectives on the performance of banking sector and financial stability of the economy. **Bansal (2012)** in the research paper "A study on recent trends in risk management of NPA by public sector banks in India" focus on management of NPA's basically of those banks which are facing difficulties to ensure the operational viability & financial soundness & making struggle to build a sound base.

Data & methodology

- Research methodology

  The study is descriptive in nature which tries to establish the relationship between willful defaulters and net profits of the banks.

  Data periodicity: studied 12 year data from 2007-08 to 2018- 19 of net profits and willful defaulters of public sector banks and private sector banks.

- **Data collection**

  Data has been collected from secondary sources.

  RBI website, banks annual reports and money control website

  CIBIL, Insolvency & Bankruptcy Board of India, National Company Law Tribunal, Lok Adalat, and different acts like SARFEASI act, IBC Act.

  Statistical tools- The statistical techniques used for analysis are simple regression and coefficient of correlation to analyze the relationship between willful defaults and banks profitability

Reasons of willful defaults

a) **Promoters Contribution**: Borrowers are expected to bring their contribution towards the loan into business. It is observed that banks were approving the loan without adequate

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worth and sources available with promoters for projected margin money that cause either delay in implementation or failure of business for the want of required margin from them. The infusion of funds by promoters are normally relied by the bankers on certificate submitted by chartered accountants. They are found fake on many occasions.

b) **Diversion of Funds**: Willful Defaulters take loans for some specific purpose but do invest money in other projects which were not being specified.

c) **High Leverage Ratio** : The debt-equity ratio for BSE 500 companies had gone up from 0.7 per cent in 2009-10 to 0.9 per cent in 2013-14, while their interest cover – a measure of a company's ability to meet interest payments - halved to 3.6 times during this period.

d) **End use of Money:** Effective monitoring of the end use of funds lent is of critical importance in safeguarding a bank's interest. It acts as a deterrent for borrowers to misuse the credit facilities sanctioned.

e) **Easy Terms & Conditions**: Banks provide very easy terms and conditions to corporate house compared to small loan holders. For eg. The recent case of PNB Fraud happened in India in which Nirav Modi (Diamond Exporter) took Loan just on the basis of undertaking signed by PNB Branch from different foreign branches of Indian banks.

f) **Outsourcing the credit marketing & project evaluation:** Influence on banks' managements by informal set of loan arrangers such as chartered accountants, retired bankers, etc, has been a roadblock.

g) **Inadequate credit skill training on Risk Assessment:** PSBs have inadequate training facility/capacity in terms of physical infrastructure and employee-trainer ratio to impart minimum skill to their employees on credit appraisal. They don't know so much about how the verifications of their projected financial statements should be done.

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RBI has taken many reforms and passed many bills for restructuring and resolution of these loans. It has passed SARFEASI Act 2002 for restructuring of loans, Lok Adalat to resolve these cases, National Company Law Tribunal also handle some cases. But a major and good step has been taken by central government and RBI is the introduction of "The Insolvency and Bankruptcy Code, 2016 (IBC)" in May 2016. With this new significant of progress – the entire mechanism for the Corporate Insolvency Resolution Process (CIRP) has been put in place. A number of rules and regulations have been notified to create the institutions and professionals necessary for the process to work. A large number of cases have entered the insolvency process, and a few have even exited the process.

Over 1,300 Insolvency Professionals are registered (under three Insolvency Professional Agencies). The first Information Utility has also started functioning. Over 525 cases of corporate insolvency have been admitted across all the National Company Law Tribunal (NCLT) benches. In addition, 108 Voluntary Liquidation proceedings and one Fast-Track Corporate Insolvency Resolution have also been initiated. In the table given below there are the cases of big corporate house which are going under resolution processes

Cases admitted for Corporate Insolvency Resolution Process under IBBC Act 2016

(Table 1)

Sr. No	**Status of CIRP**	**Number of Corporates**	
1	CIRP in progress of which*	442	
	Less than 30 days	33	
	30-150 Days	225	
	150-180 days	67	
	More than 180 Days	117	
2	Resolution plans approved	10	

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3	Liquidation order passed	30	
4	Closed by appeal/review	36	
Total CIRP petitions admitted:		525	

Source: www.nclt.gov.in

RBI has notified that there are 12 defaulters which constitute nearly 25% of total NPAs of The banks which is showing the daring of banks to grant such big amount of loans to these corporate houses and then putting it into bad loans and these are big willful defaulters of India. The list of first 12 defaulters has been displayed in the table given below**.**

List of cases referred to NCLT for liquidation proceedings and the amount of Bank Credit Default (Table 2)

Sr. No	**Company#**	**Sector**	**Claims Admitted (` Crores)**	**180 Day Period Ends On**	**Current Status of CIRP**
1	Alok Industries Ltd.	Textiles	29,912	14-01-2018	Applied for extension of 90 days
2	Amtek Auto Ltd.	Auto component	12,586	20-01-2018	Applied for extension of 90 days
3	ABG Shipyard Ltd.	Ship building	18,539	28-01-2018	CoC approved extension of 90 days
4	Bhushan Steel Ltd.	Steel	55,989	22-01-2018	In process
5	Bhushan Power and Steel Ltd.	Steel & Power Generation	48,524	22-01-2018	Extension up to 22 April, 2018
6	Electrosteel Steels Ltd.	Steel	13,302	16-01-2018	Extension up to 17 April, 2018

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7	Essar Steel Ltd.	Steel	50,778	29-01-2018	Applied for extension of 90 days
8	Jyoti Structures Ltd.	Power Transmission	8,078	31-12-2018	Extension up to 31st Mar, 2018
9	JaypeeInfratech Ltd.	Infrastructure Development	13,322	04-02-2018	Applied for extension of 90 days
10	LancoInfratech Ltd.	Power Generation	51,505	03-02-2018	Applied for extension of 90 days
11	Monnet Ispat and Energy Ltd.	Steel	10,412	13-01-2018	Applied for extension of 90 days
Total			**3,12,947**		

Data analysis

Table 3

Regression Statistics	
Multiple R	0.84
R Square	0.70
Adjusted R Square	0.68

	Coefficient	Std. error	t- statistics
Intercept	-6908.72	5285.45	-1.3071
Lending	0.0237	0.0038	6.2112
Willful default	-0.4314	0.0970	-4.4467

The present table shows the relationship between profits and lending, willful default which is 0.84 that indicates high degree of relationship. Here H_{01} H_{02} is accepted because the significance value at 5% level is 1.96 as table or critical value is (-) 1.96 more (-) 1.30 calculated value. Therefore it can be concluded that as the willful defaults are increasing then profits are decreasing which indicates the willful default have a great impact on banks in the form of losses to banks because a huge amount of profits are utilized in provisioning or writing off the willful defaults. In nutshell willful defaults are showing decreasing trend then bank's profits are

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showing increasing trend and vice versa. Here H_{02} is also accepted which implies that there is no relationship between profits and banks amount of lending because profits depends on interest rate as well default rate not on the amount of lending. There is huge amount of lending but the interest rate is less and default rate is more then there will be loss and the amount of lending is less and interest rate is more as well default rate is less then it shows profits to the banks which clearly shows the bank's profits depends on high interest rates as well low default rates rather than the quantum of lending.

Conclusion

These days increasing willful defaults is a serious problem faced by Indian banking sector which has affected financial health and capital base of Indian banks. A high level of willful defaults proposes high probability of large numbers of credit defaults that affects the profitability, net income of banks, erosion of the value & quality of assets, survival of banks and that will be contagious to growth and performance of the economy at large. Willful defaults have a great impact on bank's profitability and have a negative relation among them. As the willful defaults are increasing then bank's profits are decreasing because a major part of profits are used to write off the defaults. So banks have to control willful default and do timely supervision of projects, checking of diversion of funds from time to time and strictly following the rules & regulations while granting loans to big corporate houses are some of the ways which can prevent willful default.

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