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Wilful defaulters and the Indian banking sector: A study

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ABSTRACT

In this research paper, we analyze the increasing number of wilful defaulters in India and how certain shortcomings of the banking system contribute to this. Recently, the rising incidence of NPAs has generally caused the performance of the banking sector to decline. The paper encompasses past defaults that have occurred and how they have impacted the Indian financial sector. It is important to acknowledge how a well-structured banking sector contributes to the development of a country. We have made use of secondary data from various sources to support our assumption about the increase ofwilful defaulters.

Keywords: *Wilful Defaulters, Indian Banking Sector, Non-Performing Assets (NPAs), Capital, Finance, Bank Loans*

1. INTRODUCTION

"What is causing an increase in wilful defaulters? Does the weak banking sectorplay a role in this?"

The banking industry is an extremely important part of the financial sector and itis essential for the smooth working of the economy. It is imperative for the bankingsector to be extremely strong in order topush economic development and progresssince it plays a major role in providing opportunities, creating jobs, and boosting trade. The Indian banking system needs tobe supported to be able to survive the cutthroat competition, especially with the rise in partnerships with international prospects over the past few years. So, it is easy to see that a country's progress is strongly related to the development of itsbanking sector.

One of the major issues that cause a hindrance in setting up a healthy banking sector is wilful defaulters.Who are wilful defaulters?

Wilful defaulters are those entities who refuse to repay money even though they have the financial means to do so. This concept was first introduced when the Reserve Bank of India (in order to restrictthe increasing Non-Performing Assets (NPAs) of the Banks issued the Master Circular, under Sections 21 and 35A of the Banking Regulation Act, 1949, which defined Wilful Defaulter and detailed the measures to be adopted by Banks andFinancial Institutions (FIs) to determineinstances of default.

The increasing number of problematic loans has reshaped the overall environment for financial institutions today which is why it is important to study the credit risk management of Indian financial institutions. It has been reported that the total amount owed to Indian banks by wilful defaulters has risen more than tenfold over the past 10 years. The amount seems to have risen from Rs 23000 crore on March 31, 2012, to Rs lakh crore on May 31, 2022. According to the TransUnion Cibil, although the defaults surged to Rs 2.6 lakh crore in 2021, they have reduced a bit since then. Another point is that this data only involves those defaults in which the outstanding amount is of Rs 20 lakh or more. This rapid increase inthe amount of non - performing assets has had a significant impact not only on the financial health of these institutions but also on the economy. Consequently, analyzingthe data of wilful defaulters who have the ability to pay but are nevertheless overdue iscritical.

It is also important to note that India is the only country in which a distinction between wilful defaulters and other defaulters exists in terms of legislation. This is because there is no such thing as a wilful defaulter in othernations since they have rigorous legal actionagainst such borrowers.

- <u>History of bank defaults in the Indiancontext</u>

Different types of bank crises have been a part of India's financial history for a long time. Recent frauds were blamed on public sector banks which is why one suggestion was to implement the privatization of banks since they would provide the necessary implementations. Although, it so happens that India is plagued by both public and private sector banking failures.
As of 2021, the United forum of bank unions showed that public sector banks hada loss of approximately Rs 2.85 lakh crore due

to loan defaults by 13 corporates, even though the banks were used to support struggling financial institutions such as Yes Bank and IL&FS.

Banks are yet to recover money in the following cases: Winsome Diamonds and Jewelry Pvt Ltd (Rs 8,000 crore), Kingfisher Airlines Ltd (Rs 10,000 crore), Sterling Biotech Group (Rs 15,600 crore), Rei Agro Ltd (Rs 3,871 crore), Pixion Media Pvt Ltd (Rs 3,000 crore).

- **Yes bank crisis**

YES Bank was one of the fastest growing private banks, started by Mr Rana Kapoor and Mr Ashok Kapur. The bank had taken many tactical actions to develop corporate lending. The bank was established as thenumber 1 bank in the Business Today-KPMG Best Banks Annual Survey2008 and Mr. Rana Kapoor had made a reputation of himself as a lender to struggling firms. Although YES Bank was doing well, the NPAs started piling up and itwas revealed, in October 2017, the RBI had discovered a much larger amount of underreported NPAs reaching an amount of Rs 6355 crore.

The crisis began as a result of huge loanamounts being given to several big companies during the tenure of Rana Kapoorsuch as Essel group, Reliance, DHFL, and these firms were unable to pay back the amount in a limited period of time. 25% of these loans were given to non-bankingfinancial companies, real estate firms, and the construction sector which were the more struggling sectors of India.

Rana Kapoor was removed as the CEO which added to the deteriorating position of the bank. He was illegally lending money to companies and was not bothered with whether the loans would be returned or not. He was accused of using shell companies to receive a cut from the bank's corporate borrowers. With the loan amount increasing at a high rate, alternatively, withdrawals were also increasing. Due to the burden on the balance sheet, the bank kept showingsteady withdrawals and slowly the bank collapsed.

Some other difficulties also added to the severity of the crisis. Uttam Prakash Agarwal, an independent director at Yes Bank, resigned in January 2020, invokingthe bank's deteriorating governance. It became evident that the creditadministration in India's public sector banks is a scam. The two most important factors ofbanking, deposits, and advances have been ignored and there is no intention to obtain quality advancements. The consumer has to go through lengthy and tiring processes in order to acquire loans since desk officials are ill-equipped to manage such advances. Other factors such as false assurance to the RBI regarding the bank's strength as well as lack of serious investors also added to the problem. These consecutive events forcedthe share price of YES Bank out of control, thus making the RBI intervene to stabilize the situation. Although, negligence on thepart of the RBI and the general mishandling of the fiasco made the situation much worse.Raghuram Rajan, another former RBI governor, claimed that it was imperative for the government to get the Yes Bank rescue plan right.

- **PNB Bank scam**

India's largest financial scandal, which was planned by billionaire Nirav Modi and his associates, was exposed on February 14. It happened in the Punjab National Bankbranch in Mumbai (PNB). It is connected to LoUs that the bank issued, totaling Rs 10,000 crore.

A form of a bank guarantee is a letter of undertaking or LoU. By displaying the LoU,it enables the receiver to raise moneyoverseas. In principle, it is a deal made by one bank to another to return the loan on behalf of the consumer. When foreign bankssee the LoU, they lend the money to theborrower, and if the debtor is unable to payit back, the lending bank will do so.

In the PNB fraud, Nirav Modi received unapproved Letters of Understanding from fraudulent PNB employees. None of these transactions were notified to PNB's Core Banking System, and they were all issued without any form of credit. Corrupt officials exploited the SWIFT system, aninternational messaging network used by financial institutions to send and receive accurate and secure information, to carry outthis activity. The bank claimed that someemployees were involved in the scam since the bank's CBS was evaded when thecorrupt workers issued LOUs to foreign branches of other Indian banks using SWIFT. These foreign banks paid little attention to the credit quality of the LoUs since they did not suspect their Indian counterparts. Before it was revealed to the public, Nirav Modi, Mehul Choski, and theiraccomplices engaged in this for roughly seven years.

The fraud had a significant impact on the stock market and caused investors to losetrust in the financial industry. This fraud is the prime case of how such offenses affect other lenders and their assets. It demonstrates how corruption has crept into state banks, the core of India's financial sector.

- <u>How NPAs indicate the health of thebanking system</u>

In the normal process of issuing credit, banks receive deposits and provide loans,and the funds obtained from borrowers in the form of interest and principal repayments is used as fundraising. This is the usual cycle that is disrupted due to NPAswhich reduce bank profitability and hamper loan development.

A non-performing asset is classified as those loans and advances that are overdue for more than 90 days. These are the loanson which the principal is due and no interest payments have been made for a certain period of time. This concept was introduced in 1991 by the Narasimham Committee (Committee on financial system reforms, 1991).

The gross non-performing assets of Indian banks are projected to rise to 8-9 percent by the end of the fiscal year (FY22). These might also reach 10-11 percent since 2% of the assets will be restructured by the end of FY22, as reported by rating agency CRISIL.

The rising incidence of NPAs has generally caused the performance of the bankingsector to decline since commercial banks tend to play an important role in theeconomic condition of the country. With interest rates rising from time to time, corporates find it difficult to pay back loans,thus adding to the increase in NPAs. Since NPAs impact the profitability and liquidity of banks along with posing a risk to thequality of assets, it is extremely important toreduce the rising NPAs in the country in order to ensure the financial well-being of banks.

- **NARCL (Bad Bank)**

One of the main proposals of the 2021 budget was a bad bank that would deal with stressed assets. The National asset reconstruction company Ltd. (NARCL), according to the finance ministry, was set upin order to acquire outstanding loans of more than 500 crores from banks. Through this system, the NARCL will be able to purchase assets by making an offer to the lead bank. Although asset reconstruction companies might be able to outbid the NARCL, public and private lenders will coordinate to form the IDRC which will attempt to increase the value of these assets so as to reach a quick settlement.

The first batch of these NPAs is hoped to be handled in July and the cabinet also approved a scheme of $36000 crore in order to resolve NPAs upto Rs 2 lakh crore inorder to make way for a significant clean up of bad loans in the sector.

- What is the role of the Indianbanking system?

In the years after liberalization, the basicstructure of financial markets in India went through a major transformation. Though the process was not completely smooth, it still had mostly positive effects. Accounting for almost half of the country's financial assets, banks act as the primary credit providers in India. The RBI and government play an important role in encouraging financial inclusion in the country with the governmenttaking steps to promote banking penetration in the country with the nationalization of banks, establishment of RRBs, theintroduction of SHG along with the strategy of a one-person account for accessing financial markets. Since it is responsible for supporting many areas such as trade, industry, and agricultural requirements with adequacy, the banking sector is considered acritical factor to ensure the smooth functioning of any economy.

Thus, we note the importance of a well-structured banking sector for the well-being of a country. But it is importantto understand how corrupt the Indian banking system really is in order to acknowledge how much it benefits theeconomy.

There are some common corruption concerns that plague the Indian banking system. The fact that corruption is widespread in India's banking industry is notvery surprising. Corruption often impedesbanking activity, acting as a barrier to effective capital intermediation and therefore leaving some borrowers withoutviable options. Thus, corruption, in any form, hampers the effective allocation of capital and undermines the country'seconomic structure.

2. EQUIPMENT AND METHODOLOGY

The objective of this paper is to establish some of the factors causing an increase inthe number of wilful defaulters and how a faulty banking system plays a role in this.

We have made use of secondary data from various sources to analyze this.

Generally, corruption and collusion affect the banking sector. Firms borrow more because banks lend them more, irrespective of project viability. Whether such collusive and corrupt activities between banks and businesses occur or not is an empirical issue that only a full-fledged, independent, andpowerful "Commission of Inquiry into BankLending" can establish.

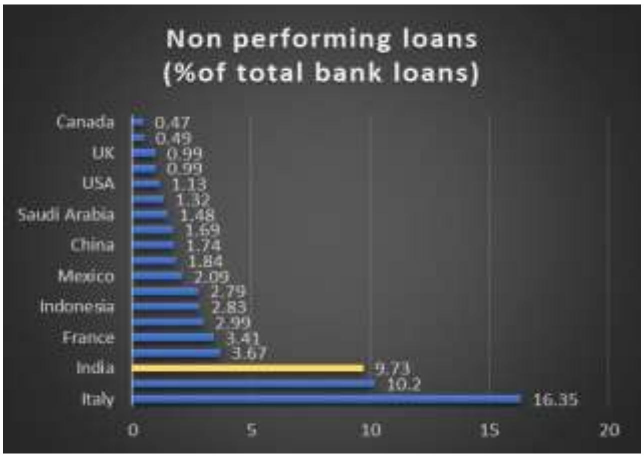
We know that a sound banking system is necessary to mobilize savings in productive sectors efficiently and a solvent banking system ensures that the bank is capable of meeting its obligation to the depositors. However, many blunders have indicated the prevalent flaws of uprising NPAs and mounting bad debts in the financial sector.

- Percentage of NPAs

Based on the data provided by IMF financialsoundness indicators, we can see that Indiais among the countries with the highest percentage of NPAs at 9.73%. The reason for such a bad ratio of bad loans in India canbe due to the ignorance of toxic assets for such a long time along with many years of tolerance. Although bad loans can occur dueto many macroeconomic factors such as economic downturn, they are also related to the economic and legal system of thecountry. Many defaulters are able to find loopholes in the system and this might be due to the weak governance of the Indian banking system.

In India itself, Maharashtra has the highest number of loan defaults in the country. It accounted for 34 percent of all loan defaults in the country. Also, the State-run Bank of Maharashtra (BoM) has written off bad loans of over Rs 11,204 crore of 42 big defaulters and Rs2,548.13 crore of small borrowers since FY13-14. The variations in the number of defaults from state to state raise the question of how the following influences the number of defaults: the extentof the power of political parties, the current governance factors as well as the influence of political parties on banking decisions. Wecan see a correlation between the level of corruption and the number of defaults in a state. Maharashtra also ranks among the states with the highest level of corruption in the country. This clearly points to how political stability impacts the condition ofthe banking system.

The stability of a country's banking and financial system influences its ability to produce and consume goods and services. It is a direct reflection of the people's well-being and living standards. As a result, if the banking system has a high level of nonperforming assets (NPAs), it is a reason for concern since it indicates financial difficulty among borrowers' clients or inefficiencies in transmission channels. The primary reason for conducting this analysis of fraud in the Indian banking sector andstudying fraud from several perspectives was the fact that the Indian economy suffers greatly from these issues.



- Regression analysis

We consider some data from a research paper from the IIMB Management Review. Several variables have been considered that affect the dependent variable.

Incremental default (Wilful Default Amount as a percentage of Gross Advances) = ∝1*Voice and Accountability + ∝2*Political Stability and Absence of Violence + ∝3*Government Effectiveness + ∝4*Regulatory Quality + ∝5*Rule of Law + ∝6*Control of Corruption + ∝7*Repo Rate + ∝8*log(Amount Recovered) + ∝9*GDP Growth Rate + ∝10*Prime Lending Rate + ∝11*Average Quarterly Exchange Rate + ∝12*lag1.log(Gross NPA) + ∝13*lag2.log(Gross NPA) + ∝14*lag3.log(Gross NPA) + ∝15*lag4.log(Gross NPA) + ∝16*Percentage of Wilful Default of Nationalized Banks + ∝0+∈i

In this equation, log values were considered for amount recovered and gross NPAs. Theregression results are reported after adjusting for heteroscedasticity.

Variables	Incremental wilful default as a percentage of gross advances – OLS regression	VIF	Incremental wilful default as a percentage of gross advances – GMM regression
Voice and Accountability	10.90**	4.88	10.90***
	−4.579		−3.587
Political Stabilityand No Violence	−2.165	12.74	−2.165
	−1.773		−1.389
Government Effectiveness	−1.501	4.84	−1.501**
	−0.902		−0.707
Regulatory Quality	−3.601*	6.79	−3.601**
	−1.873		−1.467
Rule of Law	6.139	32.51	6.139**
	−3.679		−2.882

Control of Corruption	−6.867**	13.1	−6.867***
	−2.56		−2.005
Repo Rate	0.320**	11.82	0.320***
	−0.155		−0.121
Log AmountRecovered	0.952**	20.59	0.952***
	−0.402		−0.315
GDP Growth Rate	−0.0592	1.54	−0.0592
	−0.047		−0.0368
SBI Prime LendingRate	−0.445**	38.05	−0.445***
	−0.195		−0.153
Average QuarterlyExchange Rate	0.031	20.12	0.031
	−0.0333		−0.0261
Percentage of Nationalized Banks	0.193	1.93	0.193
	−0.407		−0.319
Lag 1. log GrossNPA	0.738	72.42	0.738
	−0.704		−0.552
Lag 2. log GrossNPA	−0.323	63.18	−0.323
	−0.788		−0.617
Lag 3. log GrossNPA	−1.552*	82.09	−1.552**
	−0.795		−0.623
Lag 4. log GrossNPA	−0.0755	81.76	−0.0755
	−0.834		−0.653
Constant	−0.799		−0.799
	−16.49		−12.92
No. of observations	44		44
R-squared	0.689		

3. RESULT AND DISCUSSION

Through the above discussion on different cases of bank scams, we can understand howseveral issues in the banking system may contribute to an increase in the number of wilful defaulters in the economy. Whatever its forms, corruption in the banking industry may ultimately hinder efficient capital allocation and undermine economic growth. Apart from this, we also considered aregression analysis (based on data taken previously) which helped us further proveour point.

Let us consider the results of the regression taken above to see the relationship between the increment in wilful defaulters and several independent variables. (Result collected by IIMB Management Review, Padma N and Jayadev)

We can see that except for the rule of law and voice and accountability variables, all the other four governance variables have the desired relationship with wilful defaults, anda few are significant also, indicating that the weak governance structure of the country is strongly correlated with wilful defaults. As expected, the Control of Corruption index is negatively related with increase in wilful defaults and is also significant.

With this, even after considering many othervariables, we give most attention to the fact that a weak governance structure along with corruption have the most significant contribution to the increase in the number ofwilful defaulters.

4. CONCLUSION

Having studied the information in the paper, we can gather that a weak banking sector (among other reasons) contributes the most to the rising number of defaulters in the country. This can only be remedied with the help of active steps taken by the government. The master circular released bythe RBI regarding wilful defaulters has helped banks lessen the number of defaults. Also, for a major change in the current system, strict interventions and policies are required. Therefore, with the direct relation between a strong banking sector and lessnumber of defaulters as well as bad loans,we conclude that an appropriate plan needs to be made to resolve the problem. Over the last few years, bad loans have constantlyplagued the Indian banking system and it's time that serious actions are taken to strengthen the financial sector of the country.

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