

Wilful and Strategic Defaulting-A question on Ethics in Indian Banking System

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Abstract

The paper critically examines how the unethical practice of wilful and strategic defaulting of loans by borrowers hampers the sustainability of Indian Banking system and ruins the socio-economic development of the country. This study analyzes various issues and challenges of wilful and strategic defaults and their implications on the profitability of Indian Bank with focus on the role of regulatory framework on wilful and strategic defaults. The importance of values and ethics in the effective and efficient functioning of banking system are further highlighted. If these are not followed properly by the borrowers and bank officials, it could jeopardize the conducive environment of banks which is very important for their sustainability and profitability.

Keywords: Bank Regulation, Credit Risk Management, Values & Ethics, Indian Banking System, Non-Performing Assets, Wilful Defaults.

1. Introduction

An effective and efficient financial system is very essential for the socio-economic development and progress of a country. Non-Performing Assets is a fundamental indicator to estimate the pecuniary position of the banks. NPA is inevitable in the banking sector. As there is increase in the lending process by the banks and there is growth in credit or advances, the possibility of default also increases. Rising NPAs leads to higher probability of loan defaults which not only degrade the profitability and asset quality of banks but also affect their net worth and give high level of stress on the banks' balance sheets.

In the current period, escalating wilful and strategic defaults cause huge rise in NPAs in Indian Banking System. After the Global Financial Crisis 2007-08, it is noticed that wilful and strategic defaults are increasing corresponding to the inflating bad loans in India which has become serious issue of concern for the Indian Banks. As per records in value wilful default suits, there has been an increment from Rs. 10,299 Crores in FY 2005 to Rs. 99,954 Crores in FY 2017.^[1] It has been estimated by experts that the percentage of all strategic mortgage defaults range from 10% to 26%.^{[2][3][4]} In spite of such an effective financial system and credit risk management in India what is the reason for such a high rise in Wilful and strategic Defaults. This imposes a big question mark on the ethics in the Indian Banking System. Credit sanctioning processes not followed effectively by the banks? Is organized estimation of credit risk not done effectively in banks? Is careful confirmation of borrower's background not done by bank officials prior to loan sanctioning? Similar other questions come up which indicate that the ethics and values are not followed effectively in the loan sanctioning by the banking officials and credit borrowers. That is why there is such an abrupt rise in wilful and strategic defaults in the Indian Banking Industry. Doing strategic loan default is usually considered as being immoral act.^[2] It is considered against the values, ethics, and morality.

Ethics and values play a very significant role in the foundation to sustainability and progress of every functional business organizations. These are very essential not only for the creation of conducive environment for sustainability and socio-economic development of each business organization but also promote the sustainability of the country. Ethics and values in business also counsel on how to integrate our traditional values with modern management and emerging knowledge which is very crucial for the success in every business organizations.

This paper critically examines how the unethical practice of wilful and strategic defaulting of loans by immoral borrowers hampers the sustainability of Indian Banking system and ruins the socio-economic development of the country. This study also analyzes the issues and challenges of wilful and strategic defaults and their implications on the profitability of Indian Bank. The study also focuses on the role of regulatory framework on wilful and strategic defaults. This study highlights the importance of ethics and morality in the effective and efficient management of credit default and bad loans in the banks.

The rest of the paper is set up as follows. Section 2 is review of literature. Section 3 gives the conceptual and the regulatory framework on Wilful and Strategic Defaulters. Section 4 presents Immorality of Wilful and Strategic Defaulting and its effect on Indian Banking System. Section 5 gives the conclusion.

2. Review of Literature

The literature related with wilful default, the concept that is specific to India has been very limited. Some studies even relate increase in willful default with the increase in non-performing assets in the banks.

Sanjeev in his research study tried to identify the critical factors which are accountable for the rise in NPAs in the Indian Commercial Banks where the wilful default was found to be the most critical factor along with economic downturn.^[5]

Similarly, Bardhan and Mukherjee created a sequential game to emphasize on the event of wilful defaulting in the banks of a developing country where the borrower misreports its exact monetary status and default the loan intentionally. They also focused on the consequences of willful default which impact the banks' profitability and loan decision making procedures. They concluded that as the loan efficiency of the bank rises, the probability of wilful defaulting also rises. The banks will lend maximum possible advances if the limited liability conditions supports and conditions of wilful default are fulfilled.^[6]

Mishra in his case study of Dasarathpur block of Jajpur District in Odisha concluded that maximum number of wilful defaulters are from higher income category.^[7] Goel and Pathak in their study concluded that in 27.04% of the cases, the defaulting of the loan was made by seeing others who were irregular in repayment of their loan amount.^[8]

Further in respect of "strategic default", Trautmann and Vlahu analyzed that when the bank's anticipated potency is low, the probability that financially sound borrowers default deliberately is more. They also concluded that contagion effects can be seen in the credit market and borrowers default when other borrowers are not able to repay their loans.^[9] Guiso et.al analyzed the borrowers' tendency to default on mortgages even if they have the repayment capacity to service their debt when the value of mortgage surpass the value of house. They concluded that outlay of defaulting intentionally rises with affluence but at a diminishing pace and willingness to default strategically impacted by both financial and non-economic factors like opinions about fairness and ethicality.^[2] Seiler analyzed the effect of default willingness and financial result on the occurrence of strategic default where regarding default willingness, the strategic defaulters are considered to have acted immorally.^[10]

3. Conceptual and Regulatory Framework on Wilful and Strategic Defaulters as per RBI

The concept of the wilful default evolved in the year when 1990 when the RBI introduced the definition of "wilful defaults" in the Indian Banks.

3.1 Definition of Wilful Default and Strategic Default

RBI defined "wilful" defaults as "defaults other than those caused by genuine factors beyond the control of the borrowers".^[11]

As per master circular on Wilful Defaulters by RBI in 2015-16,

"Wilful Default: A 'wilful default' would be deemed to have occurred if any of the following events is noted:

- (a) The unit has defaulted in meeting its payment/repayment obligations to the lender even when it has the capacity to honour the said obligations.
- (b) The unit has defaulted in meeting its payment/repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
- (c) The unit has defaulted in meeting its payment/repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilized for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
- (d) The unit has defaulted in meeting its payment/repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given for the purpose of securing a term loan without the knowledge of the bank/lender.”^[12]

Similarly, strategic default can be defined as the reluctance to carry on repaying loan amount even if the borrower is financially eligible to service his debt.^[10]

3.2 Diversion and siphoning of funds

As per master circular on Wilful Defaulters by RBI in 2015-16, diversion of funds occur in case of any of the following events:-

- (a) “utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanction;
- (b) deploying borrowed funds for purposes/activities or creation of assets other than those for which the loan was sanctioned;
- (c) transferring borrowed funds to the subsidiaries / Group companies or other corporates by whatever modalities;
- (d) routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;
- (e) investment in other companies by way of acquiring equities/debt instruments without approval of lenders;
- (f) shortfall in deployment of funds vis-a-vis the amounts disbursed/drawn and the difference not being accounted for”.^[12]

As per master circular on Wilful Defaulters by RBI in 2015-16,

“Siphoning of funds occur if any funds borrowed from banks / FIs are utilised for purposes unrelated to the operations of the borrower, to the detriment of the financial health of the entity or of the lender”.^[12]

3.3 Cut-off Limits

As per master circular on Wilful Defaulters by RBI in 2015-16,

The present cut-off limit fixed by the Central Vigilance Commission is Rs.25 lakh for reporting wilful default cases to RBI by financial institutions. If a wilful defaulter is found with an unpaid amount of Rs.25 lakh or more then penal measures has to be taken against him.^[12]

3.4 Penal Measures

As per master circular on Wilful Defaulters by RBI in 2015-16^[12]

The strict measures which must be taken by the financial institutions against the wilful defaulter are:-

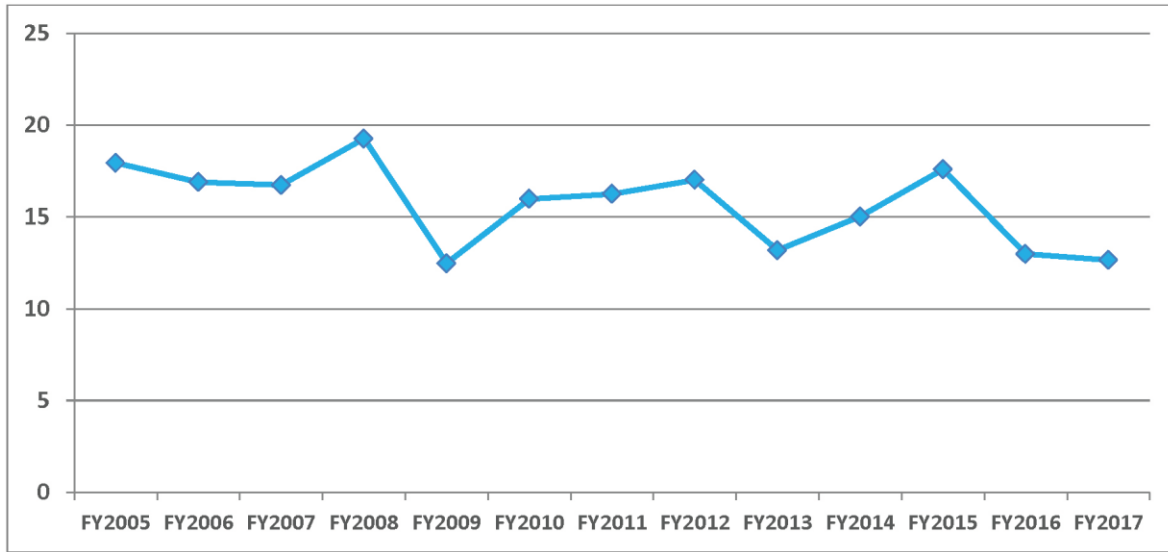
1. The listed wilful defaulters should not be granted any additional facilities by any bank or financial institution.
2. The companies which are found doing diversion or siphoning of funds, fraudulent transactions, misrepresentation etc must be prohibited from financial aid from banks.
3. The legal process and criminal proceedings wherever permitted for recovery of debt against the wilful defaulter should be initiated promptly.
4. The financial institutions should implement a practical approach for a change of management of the wilful defaulters wherever possible.
5. The borrower must not initiate a person on its board who is in the Wilful Defaulters list.

4. Immorality of Wilful and Strategic Defaulting and its impact on Indian Banks

The unethical practice of wilful and strategic defaulting of loans by immoral borrowers hampers not only the sustainability of Indian Banking system but also ruins the socio-economic development of the country. Doing strategic loan default is usually considered as an immoral act.^{[2][13]} They default on mortgages even if they have the repayment capacity to service their debt when the value of loan surpasses the value of house. It is considered against the values, ethics, and morality. Similarly, Seiler analyzed the effect of default willingness and financial result on the occurrence of strategic default where regarding default willingness, the strategic defaulters are considered to have acted immorally significantly and consistently.^[10]

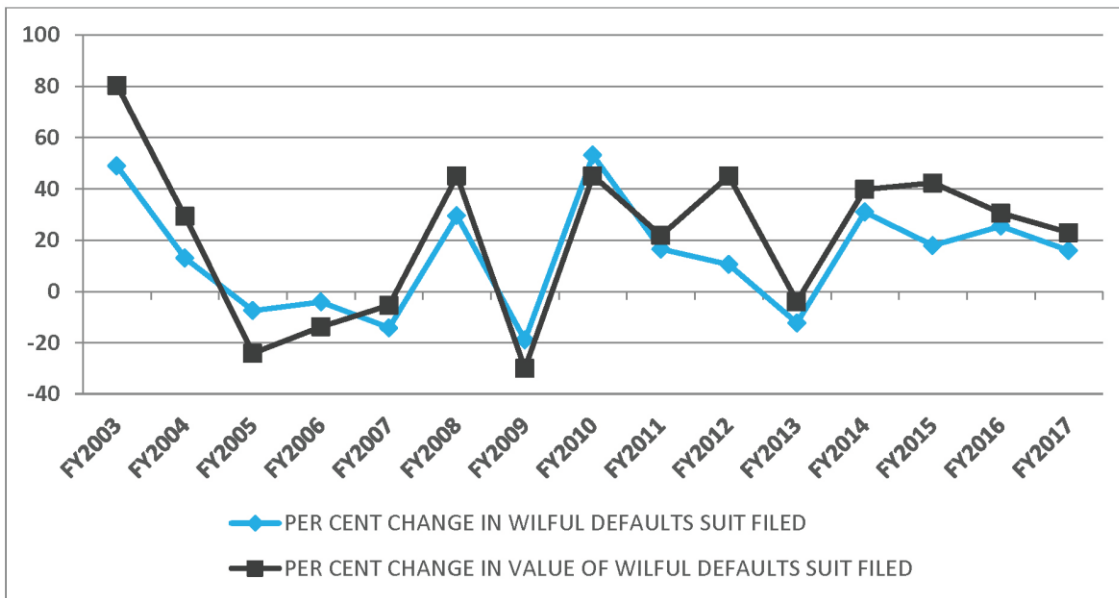
In the current period, escalating wilful and strategic defaults cause huge rise in NPAs in Indian Banking System. After the Global Financial Crisis 2007-08, it is noticed that wilful and strategic defaults are increasing corresponding to the inflating bad loans in India which has become serious issue of concern for the Indian Banks. It has been estimated by experts that the percentage of all strategic mortgage defaults range from 10% to 26%.^{[2][3][4]} As per records in value wilful default suits, there has been an increment of Rs. 10,299 Crores in FY 2005 to Rs. 99,954 Crores in FY 2017.^[1] As per report of PHD Chamber of Commerce and Industry there has been an increment in Gross advances from Rs. 2503431 Crore in FY2008 to Rs. 8476705 Crore in FY2017. Similarly, there has been also a rise in gross NPAs from Rs. 56606 Crore in FY2008 to Rs. 790268 Crore in FY2017.^[1] Hence it is seen that there has been such a abrupt rise in wilful default and gross NPAs post global financial crisis 2008. NPA is a crucial indicator to estimate the pecuniary position of the banks. Rising NPAs leads to higher probability of loan defaults which not only degrade the profitability and asset quality of banks but also affect their net worth and give high level of stress on the banks' balance sheets.

Figure 1: Wilful default to GNPA's (in percent)



As per Fig. 1, the ratio of wilful defaults to GNPA's was 17.9 percent in 2005 which decreased to 12.6 percent in 2017.

Figure 2: Suit-filed accounts of Wilful defaulters (Rs. 25 lacs and above)



It is observed that the asset quality of Scheduled Commercial Banks deteriorated between March and September 2017 across broad sectors due to such high rise in wilful defaults and gross NPAs. GNPA ratio of Scheduled Commercial Banks increased from 9.6% to 10.2% between March and September 2017^[1]. Bank asset quality and failure of banks is an indicator of insolvency. Piling up of NPAs is the major cause of banking crisis which had further made many banks insolvent.^{[14][15][16][17]} The overall profitability of banks decrease with increase in NPAs. It is found that the bank profits decrease with rise in NPAs.^{[18][19][20]} Banks' efficiency also decreases with the rise in

NPAs and it is negatively related with NPAs.^{[21][22][23][24][25][26]} High NPAs tend to decrease measured cost efficiency of banks.^[27]

Hence it is observed that rise in NPAs, wilful and strategic defaults which are considered highly as immoral and unethical act not only adversely impacts the profitability, asset quality, solvency and efficiency of banks but also gives a high level of stress on the banks' balance sheets. It hampers the sustainability and progress of Indian Banking system. An effective and efficient financial system is very essential for the socio-economic development and progress of the country which can be only achieved if the ethics and moral values are followed in banking sector and every financial organization.

But if the banking system is inefficient and ineffective then there cannot be a sound economy. The country cannot have a sustainable growth and socio-economic development if its financial system is not strong and ethical culture is not followed there.

5. Conclusion

It is seen that the rise in wilful and strategic defaults plays a major role in the rise of Non-Performing Assets in the Indian Banking System which is highly an act against the morality and ethics in banking business. After the Global Financial Crisis 2007-08, it is noticed that wilful and strategic defaults are increasing corresponding to the inflating NPAs in India which has become serious issue of concern for the Indian Banks. Hence the increasing number of wilful defaults, strategic defaults, and NPAs should be controlled and managed effectively. To accomplish this objective, certain corrective measures must be taken by the Indian banks and Governments. To alleviate the impact of wilful and strategic defaults banks should keep a careful watch on corporate activities after the loan is sanctioned to the borrowing unit. Banks should improve their credit sanctioning processes and monitor the progress of loans effectively. Banks should train their officials more efficiently for the loan sanctioning activities and make effective resolution plans. Banks should track their secret and unspecified assets effectively.

In order to reduce the impact of wilful and strategic defaults on the Indian Banking System, banks should do detailed verification of background of the borrowing unit before loan sanctioning. Banks should do systematic quantification and evaluation of credit risk. Banks should frame loan waiver schemes for the priority sector borrowers and minimize their dependence on restructuring of loans. Consolidation of various banks is very important in order to build healthier banking system to tackle the issue of wilful and strategic defaults.

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