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Factors Determining the Loan Default Risk of Individual Borrowers of Banks: An Empirical Study

Shagufa Ali,
Asst. Professor, School of Management, Graphic Era Hill University, Dehradun Uttarakhand India
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Abstract

The most crucial component of financial system is bank, particularly for an economy like India. Any issue that results from it has the potential to affect other areas of the nation. India has developed a strong, adaptable, and effective financial system to help it accomplish its economic objective. Despite developing a well-coordinated financial system, Indian banks continue to guard against serious dangers that might send the economy down an unsettling road. For the banks to remain viable in the market for an extended period, it is essential that they manage risk effectively. Banks are the most important resource for anyone wishing to borrow money for a specific reason. The borrower is required to pay back the loan with the agreed-upon interest. Sometimes, for a variety of reasons, the borrower is unable to pay the interest. The loan that the buyer has taken is referred to be a default risk when the bank determines that the specific buyer may not be able to repay the loan in full. The risk of loan default for a certain borrower is caused by a number of factors.

Keywords: Default Risk, Credit Risk, Banking System, Market Risk, Commercial Banks

Introduction

Risk is the most abominated area of the financial system, mainly the banking system, but it the also the most connected area which is not avoided. It is the same factor in which the whole banking system operates. There are mainly three types of risks in a banking system. Market risk, Operational risk, and Credit risk. Market risk is the chance that an investor would experience losses as a result of the variables affecting the overall performance of the financial markets in which the investor invests. Equity, interest rates, currency risk rate, and other market risks are present in the banking system. Market risk, also known as systemic risk, cannot be completely eliminated through diversification. Operational risk is the risk that a business takes on when it

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tries to operate in a certain sector or locale. The form of risk that is not a component of financial risk or market-wide risk is operational risk. It results from shortcomings in the internal system and internal processes. The likelihood that a bank borrower won't be able to comply with the loan's conditions and other requirements is known as credit risk. By keeping credit risk exposure at a tolerable level, credit risk management aims to increase a bank's risk-adjusted rate of return. Both the overall portfolio risk and the risk associated with each individual loan or transaction should be managed by banks. The connections between credit risk and other hazards must be considered by banks. Every bank's contingency risk management strategy must include credit risk management as it is crucial to long-term profitability. According to economic theory, market risk and credit risk are inextricably linked and cannot be differentiated from one another. Credit risk is impacted by the potential for default when the market value of the company's assets changes drastically. Additionally, if the likelihood of default increases abruptly, it raises credit risks, which lowers the company's market value and raises market risk (Agrawal, & Sehgal, 2018 and Zergaw, F. (2019).

Default risk arises when the borrower fails to comply with the requirements provided under that contract. A breach of a debt contract on the side of debtor is known as default risk. When the lender realizes that the borrower might fail to repay the loan, then the risk arises from the failure is known as default risk. It is important for the bank to predict and avoid the default risk to achieve long term objectives. It is important for the bank to estimate the probability of default, which means to estimate that the borrower of a loan might get into default. As the cases of bankruptcy and willful defaulters are arising, the estimation of probability of default has gained higher importance in today's world. To mitigate the risk faced by the bank they are required to maintain regulatory capital for credit risk, operational risk and market risk (Topalogu, 2010).

Literature Review

According to studies, one of the main goals of financial analysis is to estimate the possibility of default. A few factors can predict the possibility of default. Large corporations like Moody or S&P to calculate the likelihood of default use these characteristics. These parameters include the asset liabilities ratio, coverage ratio, business prospects, dividend in other payments, and default recovery ratio. To determine an organization's default probability, these factors are determined.

By using a variety of variables, default probability of an individual can be predicted. (Sharma, Singh, Upadhyay, 2014).

It was discovered that studying the borrower profile is crucial for predicting a person's default risk. The borrower's profile includes a timeline for loan repayment. It could be either longer or shorter. A longer-term means times more than five years. Longer-term borrowers have lower risk scores than shorter-term borrowers, live in lower-income slabs, and use their credit cards more frequently. Loan terms, credit scores, yearly income, and line recycling rates are the protective factors that have an adverse effect on an individual's risk of default. It demonstrates extending the loan term, raising credit score, raising yearly income, and increasing line recycling rate may all help to lower the risk of loan default. Loan interest rate, debt-to-income ratio, and the amount of negative public records are risk variables that have an influence on a person's likelihood of defaulting on a loan. It suggests that if borrowing rates, debt-to-income ratios, and the amount of negative public records rise, the likelihood of loan default also rise. (An, Cordell, Tang, 2020).

According to a study, interest rates are a gauge of how expensive it is to borrow money. It also refers to the fee for a loan. It is the expense associated with borrowing money and is frequently stated as a percentage of the borrowed amount. Taking out a loan costs more when the interest rate is high. The borrower's ability to repay the loan reduces because of increased interest rates since they increase the amount of the installment paid after a particular amount of time as defined in the loan's terms and conditions. As a result, a higher interest rate loan frequently performs poorly after that. Default on loans and interest rates are closely related. One factor that affects the likelihood of a loan default is the interest rate. A loan's high interest rate makes regular payments challenging by raising the installment amount. Once again, when interest rates are high, the minimum rate of return on investments is similarly high, which makes it difficult for investments to be profitable. A loan might be used for anything different than what it was meant for. A loan can be utilized for business, personal, or even debt repayment objectives. However, if diversion is used ineffectively, it might have an impact on how quickly loans are paid back. The risk of a loan default increases when a borrower utilizes it for purposes other than those for which it was obtained. Loan diversion is one of the main reasons for defaults. Loan diversion thus significantly raises loan default. Collateral is the security for a loan. Since the

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lender may recoup the loan by selling the collateral, collateral lowers the risk of default. If the borrower places a high value on the collateral because the lender has the right to take it back, they will be more cautious about repaying the loan. As a result, there is very little chance of default. Borrowers may be negligent in repaying loans if recovering the collateral is not necessary to them, which might increase the chance of default. The lender may rely more on the borrower's creditworthiness than on security to guarantee repayment of a modest loan. Small loans frequently have a lower default rate than large ones. However, if the loan is substantial, the lender will also consider extra collateral in addition to the borrower's creditworthiness. Because of this, huge loans frequently come with collateral. The ability to repay a debt is closely related to income. So, it is believed that a borrower's monthly income will have a big impact on loan repayment. It goes without saying that a borrower will have a high payback capacity if they get a significant monthly income from a variety of sources, including from their present loan. On the other side, if the borrower has a low monthly income, the loan will perform poorly (Uddin, M. (2019).

In research, it was estimated that financially analyzing the client is crucial to lowering default and credit risk. Studying the customer's credit using the five components of the resolution is also crucial. These five components of resolution make up the so-called 5Cs credit-based approach. Character refers to a person's or a company's reputation for wanting to be paid. It is possible to determine the client's reputation and the market in which the client competes by researching the client's past. The ability of the customer or individual to repay the loan must also be considered by the bank. Therefore, capacity fair Bank analyses an individual's financial accounts and cash flow in the second credit-based model. The third C, capital, is a crucial component of credit decisions that considers a person's firm size, sales, cash flow, and market share. Collateral, the fourth C, is what decides and lowers a customer's or an individual's credit risk. Collateral may take the form of monetary insurance, private sponsorship, real estate, a vehicle, a structure, or any other kind of security. The fifth credit model is condition, which refers to the terms under which the bank has approved the loan. A recession or other difficult economic situation may have a negative influence on interest rates (Srikanth, & Kishore, 2014).

In research, it was found that due to the increase in numbers of willful defaulters and arising risk related to credit, banks need to maintain a robust mechanism for Credit Risk Management. Banks

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are equipped with credit risk management (CRM) competence to recognize vulnerabilities, manage credit risk proactively, and optimize credit risk. To achieve CRM proficiency, one must put in place relevant organizational structures, appropriate policies and strategies, and suitable operations and systems at both the transactional level and the portfolio level. The introduction of new credit instruments, increased market competition, and the complexity of the legal and regulatory environments are some of the main factors pushing banks to adopt more advanced procedures and move along the path of capability maturity in CRM. Reduce the possibility of loss from a credit transaction as much as possible while using risk management techniques successfully. To meet banks' aims and objectives, this is required (Jayadev, & Padma, 2020 and Basu, Satsangi, 2019).

Credit risk is by far the biggest risk that banks are exposed to, claims research. The success of their operations depends more than any other risk on an accurate evaluation and effective management of this risk. The marginal cost of debt and equity rises when credit risk does, raising the cost of capital for the bank. Uncertainty in the financial markets, project failures, legal obligations, credit risk, accidents, natural disasters, and enemy-initiated assaults are just a few examples of the many varied shapes that credit risk may take. Assigning the risk to a third party, avoiding the hazard, limiting its negative effects, and accepting some or all the repercussions of a certain risk are some examples of risk management tactics. Banks place a high emphasis on credit risk management since it is essential to the loan application process. To protect the bank from the negative consequences of credit risk, it maintains credit risk exposure to maximise bank risk, adjusted risk rate of return (Arora, Kumar, 2014 and Spuchľáková, Valaškováb, Adamkoc, 2015).

Objective:

To find the Factors Determining the Loan Default Risk of Individual Borrowers of Banks

Methodology

This study is descriptive in nature in which data is obtained from 176 respondents working in the banking sector. A checklist question was used to analyze and interpret the data. In a checklist question respondents choose “Yes” or “No” for all the questions.

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Table 1 Factors Determining the Loan Default Risk of Individual Borrowers of Banks

	Factors Determining the Loan Default Risk of Individual Borrowers of Banks	Yes	%Yes	No	%No	Total
1	Interest rate determines the loan default risk of an individual	149	84.66	27	15.34	176
2	Unimportant collateral determines the loan default risk of an individual	138	78.41	38	21.59	176
3	Income determines the loan default risk of an individual	152	86.36	24	13.64	176
4	Loan size determines the loan default risk of an individual	158	89.77	18	10.23	176
5	Tenure of loan payment determines the loan default risk of an individual	147	83.52	29	16.48	176
6	Market risk determines the loan default risk of an individual	161	91.48	15	8.52	176
7	History of client determines the loan default risk of an individual	142	80.68	34	19.32	176
8	Desire to repay the loan determines the loan default risk of an individual	133	75.57	43	24.43	176

Table 1 shows that 91.48% respondents agree that Market risk determines the loan default risk of an individual while 89.77% respondents agree that Loan size determines the loan default risk of an individual. 86.36% respondents agree that Income determines the loan default risk of an individual while 84.66% respondents agree that Interest rate determines the loan default risk of an individual. 83.52% respondents agree that Tenure of loan payment determines the loan default risk of an individual while 80.68% respondents agree that History of client determines the loan default risk of an individual. 78.41% respondents agree that Unimportant collateral determines the loan default risk of an individual while 75.57% respondents agree that Desire to repay the loan determines the loan default risk of an individual.

Conclusion

The above study concludes that the financial system's most crucial component is the bank, particularly for an economy like India. Any issue that results from it has the potential to affect

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other areas of the nation. India has developed a strong, adaptable, and effective financial system to help it accomplish its economic objective. Despite developing a well-coordinated financial system, Indian banks continue to guard against serious dangers that might send the economy down an unsettling road. For the banks to remain viable in the market for an extended period of time, it is essential that they manage risk effectively. The most crucial source for anyone looking to borrow money for a certain purpose is banks. When the borrower disregards the conditions outlined in that contract, default risk develops. Default risk refers to a debtor's violation of a debt obligation. Default risk is a threat that occurs when the lender anticipates that the borrower could default on the loan. To accomplish long-term goals, the bank must anticipate and minimise the risk of default. It is crucial for the bank to calculate the probability of default, or the likelihood that a loan borrower would go into default. Estimating the likelihood of default has become more crucial as incidences of bankruptcy and willful defaulters increase. Interest rates and loan default are closely associated because high interest rates make it harder to make regular payments and because they set a high bar for what constitutes a profitable rate of return on investments. The risk of default rises since loan diversion is a significant cause of defaults. By enabling the lender to recoup the debt, collateral serves as a security for the loan and lowers the risk of default. Large loans sometimes have collateral attached, although small loans frequently have a lower default rate than big ones. The ability to pay back a loan depends in part on the borrower's ability to make ends meet each month.

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