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EXAMINING THE IMPACT OF LOAN DEFAULTS ON COMMERCIAL BANKS: CHALLENGES, RECOVERY STRATEGIES, AND EFFECTIVENESS OF MITIGATION MEASURES

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ABSTRACT

Background: This study investigates the impact of loan defaults on commercial banks, examining factors influencing default rates, recovery challenges, and the effectiveness of various mitigation strategies.

Objectives:1. To analyze the effects of loan defaults on commercial banks. 2. To understand and address the problems encountered during loan recovery. 3. To evaluate measures that could help reduce the incidence of loan defaults.

Methods: A survey research design was employed, with a sample size of 75 participants. Primary data were collected through structured questionnaires distributed to bank employees, focusing on loan types, recipient demographics, default rates, and recovery challenges. Secondary data were obtained from textbooks, journals, and scholarly articles. Statistical tools used include percentages and Chi-square tests for data analysis.

Results: The study found that the majority of loans granted were short-term (58.67%), with industrial loans receiving the largest share of 52%. Key problems in loan recovery included difficulties in locating defaulters (54.66%) and insufficient collateral (30.67%). Corporate enterprises were identified as the highest contributors to loan defaults (61.33%), while personal loans had the highest repayment rates (64%). Legal action was the most common strategy for reducing defaults (57.33%).

Conclusion: The study highlights significant sector-specific default rates and the predominance of legal action in recovery efforts. The findings suggest that tailored risk management strategies and improved collateral policies are necessary to mitigate loan defaults.

Future Directions: Future research should explore alternative recovery strategies, investigate sector-specific default causes, and assess the impact of economic conditions on loan repayment behaviors. Evaluating the effectiveness of different interventions could further enhance credit management practices.

Keywords: Commercial Banks, Loan Granting, Loan Recovery, Debt, Financial performance, etc.

I. INTRODUCTION

Banking system is the backbone of Indian economy. A collection or network of organizations that offer us financial services is called a banking system. These organizations are in charge of managing an exchange, lending money, accepting deposits, and assisting with investments. The Reserve Bank of India (RBI), which serves as the country's central bank, is joined in the banking system by commercial, cooperative, and development banks (also known as development finance institutions).These organizations serve as the hub of India's financial industry by acting as a gathering place for investors and savers. Banks are crucial to the development of developing nations because they facilitate the mobilization of resources and their more effective allocation. The nationalization of the RBI in 1949 and the Imperial Bank of India, which is now known as the State Bank of India, in 1950 marked the beginning of India's banking sector's growth. A bank's two main operations are loaning money and taking deposits. One way to profit from this is to provide deposits at a lower interest rate than you would charge for loans. Commercial banks typically lend large sums of money to a variety of clients at varying rates according to their risk tolerance. Moreover, this raises the possibility of debt defaults. When a borrower doesn't return the loan amount plus interest according to the original agreement, it's called a loan default.

During the last decade, the loan quality and portfolios in many nations across the globe were relatively constant until the onset of the 2007-08 financial crisis. Subsequently, the bank assets saw a rapid fall in quality due to the global economic slump. The correlation between loan performance and a country's economy is a well-established fact. However, the drop in loan performance has not been uniformly seen across all global economies. Default occurs when a person fails to make the required payment of interest or principal on a debt. Creditors must carefully assess the default risk when granting loans to borrowers. Defaulters might include individuals, corporations, or even whole nations. Typically, when borrowers fail to pay the interest or principle amount, lenders and banks usually provide a grace period before resorting to punitive measures against the defaulters. "Once the grace period is expired, the individuals who have defaulted on their loan are compelled to sell their pledged asset in order to collect the money." However, if no assets were originally used as collateral when borrowing a loan, then that loan is classified as a bad debt and is wiped off. Failure to make a loan payment may result in a significant and enduring decrease in the borrower's credit score, and future loans will be offered at a very high interest rate.

II. REVIEW OF LITERATURE

S. Radhika (2014) in her research article ‘A study on financial performance with respect to loans & advances, studied cooperative banks found that the comparison of total loans & advances shows the increase in the amount of lending over 2012- 14 (2012 as base year) and, deposits also increased yr-on-yr. but the advances on bills discounting is constant.

In his research paper titled ‘The financial performance of loans and advances of Godavari co-operative bank ltd,’ Ratnaparkhe Gajanan (2015) aimed to reassess the operations of cooperative banking growth in India. The research has assessed the bank's performance throughout the timeframe of 2009-2014. He discovered that there is a gradual and sluggish increase in lending behaviour.

Vivek Rajbahadur Singh (2016) conducted a study to analyse the trend of Non-Performing Assets (NPAs) and their recovery in Indian scheduled Commercial banks from 2000 to 2014.

The study utilised secondary data from public sector banks, private sector banks, and foreign banks listed in the second schedule of the Reserve Bank of India Act, 1934. The research was condensed utilising Gross and Net Non-Performing Assets (NPAs) together with visual representation. It demonstrates that the funds tied up in NPAs have a direct influence on the bank's profitability, particularly in public sector banks where it is notably elevated.

The authors Rehman et al. (2019) The objective of this research is to investigate the risk management measures used by the commercial banks in Balochistan, Pakistan, in order to reduce or eliminate credit risk. The study's results are crucial because they provide commercial banks with an understanding of the efficacy of different risk management measures, which they may then employ to minimise credit risk. This research examines the perspectives of personnel from certain commercial banks about effective ways for reducing credit risk. Data was gathered from a sample of 250 individuals working in commercial banks in order to conduct multiple regression analyses, which were used for the study. The findings revealed that there are four key factors that influence credit risk management (CRM): corporate governance has the most important effect, followed by diversification, which also plays a considerable role, hedging, and lastly, the bank's Capital Adequacy Ratio. This research emphasises the need of implementing these four risk management techniques in order for commercial banks to effectively address and mitigate credit risk.

Ojong Opa, Valentine, and Tabe-Ebob, Wendy. (2020) The objective of this research, titled 'The Effects of Loan Default on Commercial Banks Profitability, Case Study BICEC Limbe,' was to evaluate the impact of loan default on the financial performance of commercial banks in Cameroon. The research aimed to analyse the variables contributing to loan defaults by borrowers and their impact on the profitability of commercial banks in Cameroon. Additionally, it sought to investigate the characteristics specific to BICEC bank in Limbe that influence its profitability in Cameroon. This study used a quantitative research methodology and utilised a standardised questionnaire to gather data from all the staff members of BICEC Limbe. The study used purposive sampling to choose participants, and the acquired data underwent descriptive analysis, measures of central tendency, correlation analysis, and regression analysis. The research highlighted character, capacity, collateral, condition, monitoring, screening, payback maturity, and interest rates as the key characteristics that impact the profitability of BICECs. Their link with profitability was positive and substantial, leading to the acceptance of the theory. A suggestion was made for commercial banks in Cameroon to reassess current interest rates and ensure they are equitable for all consumers. Additionally, it is advised to establish efficient monitoring systems to facilitate screening and oversight of operations and activities.

R. Revathi and M. Thinesh Kumar (2022) This study was conducted to evaluate the issues related to loan approval and recovery in SBI Banks. The study aimed to accomplish the following objectives: In order to identify the many challenges associated with loan recovery, analyse the impact of loan default on SBI banks, and provide strategies to mitigate the occurrence of loan default. Data that was pertinent to the topic was gathered from primary and secondary sources. Additionally, the customer's disposition towards loan repayment. The major data collecting tool used was questionnaires, while secondary data was obtained from several relevant publications. Prior to approving a loan, it is essential for the lenders to thoroughly analyse the project statement provided by the customer or borrower. This examination will enable them to determine the practical payback schedule and assess the feasibility of the projects based on the client's historical track record.

III. OBJECTIVES OF THE STUDY

The main objectives of the research study are as follows:

1. To analyze the effects of loan defaults on commercial banks.
2. To understand and analyze the several problems facing loan recovery.
3. To measures that will help to reduce the incidence of loan default.

IV. RESEARCH METHODOLOGY

4.1 Research Design

In this study, a survey research design is used. To enable the extrapolation of results to a larger population, a representative sample of the population was chosen to collect and process data.

4.2 Sample Size

There are seventy-five participants in this study.

4.3 Data Collection

Primary Data: The responses to a structured questionnaire given to bank employees served as the main source of primary data collection. The purpose of this survey was to obtain information about the types of loans made, the number of recipients, the frequency of loan defaults, and the timeliness of loan repayments.

Secondary Data: Textbooks, scholarly journals, and other publications were among the many sources from which secondary data were collected.

4.4 Statistical Tools

To obtain important insights, the gathered primary data were statistically examined using methods like percentages and Chi-square tests.

4.5 Hypothesis

H_o: The frequency of loan defaults is not decreased by the actions taken by banks.

Ho_1: Banks' actions lower the frequency of loan defaults.

V. ANALYSIS AND INTERPRETATIONS

Table 1: Type of loan grant

Particulars	F	%
Long-term	10	13.33%
Short-term	44	58.67%
Medium-term	21	28%
Total	**75**	**100**

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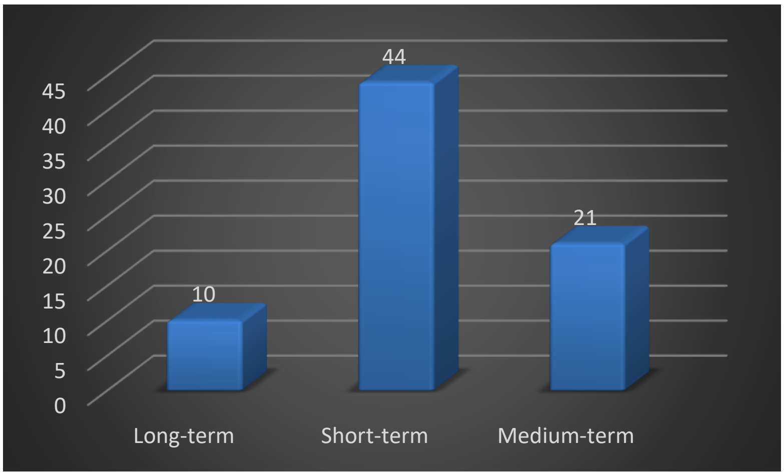
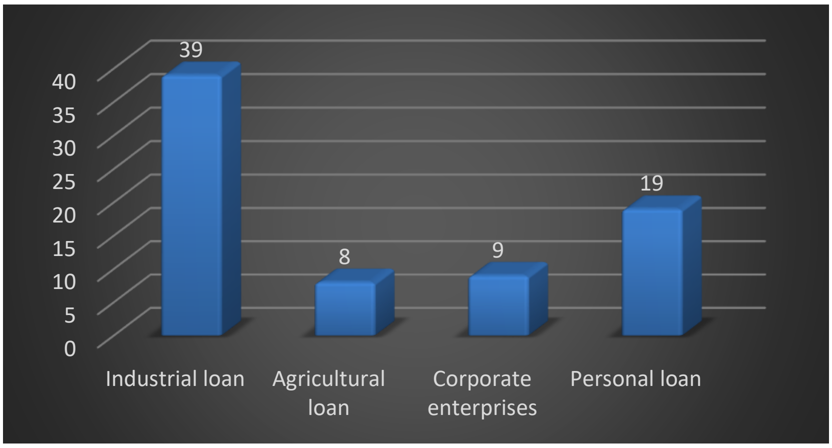


The distribution of the various loan kinds that the commercial bank has granted is shown by the data in Table 1. The bulk of loans that are given out—58.67% of the total—are short-term, indicating that the bank mostly uses lending strategies that call for shorter payback terms. This emphasis on short-term loans might be a reflection of the bank's strategy to better manage liquidity, lower its exposure to long-term credit risks, and satisfy the short-term lending needs of borrowers.

On the other hand, only 13.33% of all loans are long-term, suggesting a more cautious approach to lending for prolonged periods of time. Of all the loans made, 28% are medium-term loans, which are in between the short- and long-term categories. This distribution points to a balanced approach on the part of the bank, with a sizeable portion of its lending portfolio devoted to medium-term loans, which may serve borrowers seeking funding for investments or projects with a moderate payback period. The bank's focus on reducing risk while offering a variety of loan options to satisfy different borrower needs is reflected in the distribution as a whole.

Table 2: Sectorial allocation of loan

Particulars	F	%
Industrial loan	39	52%
Agriculturalloan	8	10.67%
Corporateenterprises	9	12%
Personalloan	19	25.33%
Total	**75**	**100**



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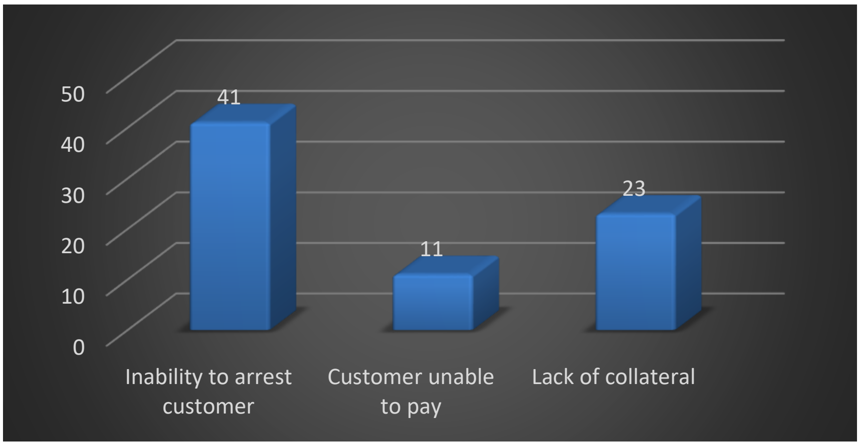
The commercial bank's loan allocation by sector is shown in Table 2. According to the data, 52% of all loans granted fall into the category of industrial loans, which make up the largest portion. "The bank appears to prioritise supporting companies engaged in manufacturing and production, which are important contributors to economic growth and stability, based on the sizeable allocation it has made to the industrial sectors." The bank's emphasis on industries with longer-term economic impact and potentially higher returns is indicated by the sizeable share of industrial loans.

By contrast, loans for agriculture account for only 10.67% of the total, indicating a lesser priority placed on helping the agricultural sector. Of all loans, 12% are made to corporate entities, and 25.33% are made to individuals. This distribution shows the bank's balanced approach to serving both individual and business clients, with a notable portion of personal loans and a moderate engagement with corporate entities. The comparatively smaller percentage of loans to the agricultural sector may indicate a strategic decision or be a reflection of the industry's perceived risk profile and borrowing requirements.

Table 3: Problems faced during loan recovery

Particulars	F	%
Inabilitytoarrestcustomer	41	54.66%
Customerunable topay	11	14.67%
Lackof collateral	23	30.67%
Total	**75**	**100**

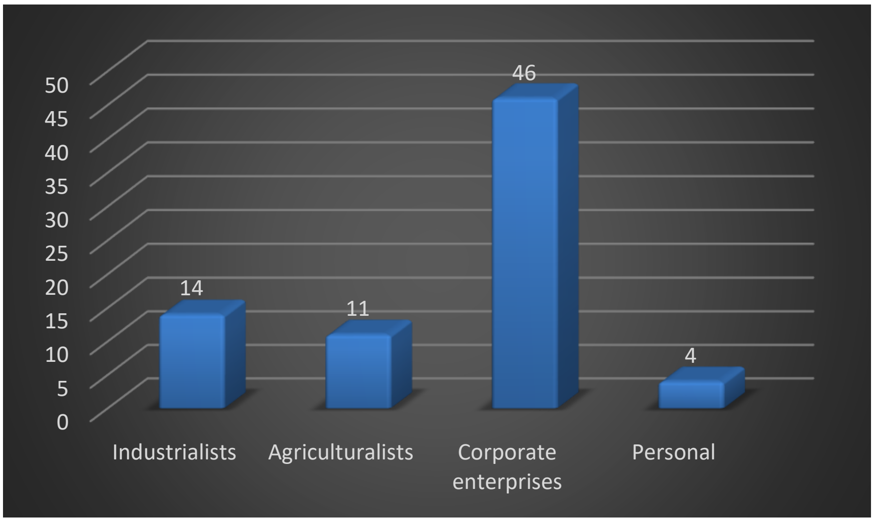


The issues that the bank ran into when trying to collect loans are listed in Table 3. The most common problem, which affects 54.66% of cases, is the incapacity to capture borrowers who fall behind on their payments. This implies that finding and collecting from borrowers may present significant logistical or legal challenges, which could impede the bank's recovery efforts and jeopardise its overall financial stability.

Lack of collateral is a major contributing factor to 30.67% of the issues, suggesting that many loans were given out without enough security, which makes recovery more challenging when defaults happen. By contrast, customers' inability to pay accounts for only 14.67% of the problems. This suggests that although problems with repayment do arise, they are less common than problems with customer tracking and insufficient collateral. This distribution emphasises how crucial it is to enhance recovery procedures and reevaluate collateral policies in order to reduce the risks related to loan defaults.

Table 4: Defaulters of loan repayment on sectorial

Particulars	F	%
Industrialists	14	18.67%
Agriculturalists	11	14.67%
Corporateenterprises	46	61.33%
Personal	4	5.33%
Total	**75**	**100**



The distribution of loan defaulters by sector is shown in Table 4. According to the data, corporate enterprises account for 61.33% of all loan defaulters, making them the largest contributors to defaults. This noteworthy proportion implies that corporate loans are more likely to default, maybe as a result of increased financial strain or unstable economic conditions that affect companies. This trend emphasises how important it is for banks to apply efficient risk management techniques for this industry and to examine corporate loan applications with greater rigour.

By comparison, personal loans account for a mere 5.33% of all defaults, suggesting that defaults within this category are comparatively infrequent. 14.67% and 18.67% of the defaults are attributed to agriculturalists and industrialists, respectively. Even though these sectors' share of defaults is smaller than that of corporate enterprises, it is still a sizable portion of the total. The observed sectoral distribution highlights the disparities in risk attached to distinct loan categories and implies that tailored interventions might be imperative to tackle the unique obstacles encountered by individual sectors.

Table 5: Highest rate of loan repayment on sectorial

Particulars	F	%
Industrialists	13	17.33%
Agriculturists	8	10.67%
Corporateenterprises	6	8%
Personal	48	64%
Total	**75**	**100**

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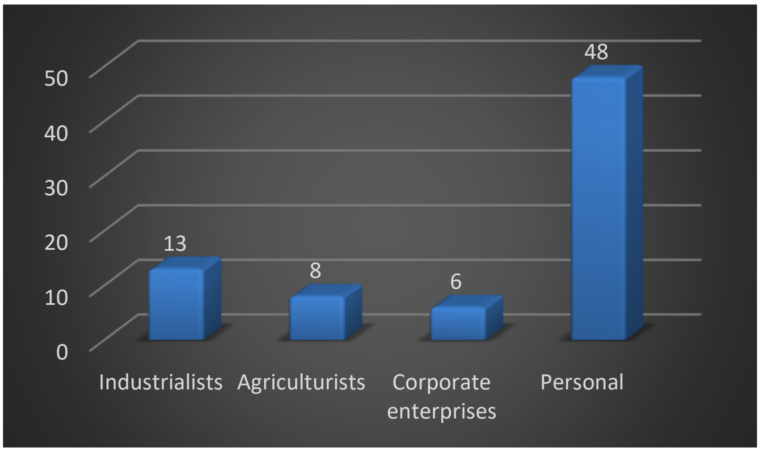
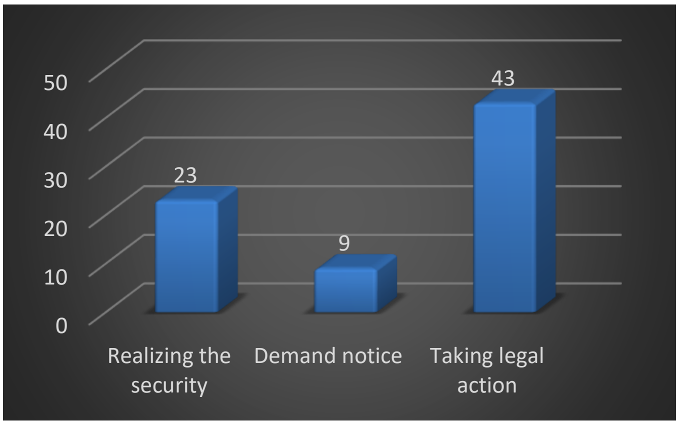
The highest loan repayment rate for each of the sectors is shown in Table 5. Of all loan types, personal loans have the highest repayment rate—64 percent of borrowers make timely loan payments. This significant number suggests that personal loans are typically repaid on time, indicating a high level of commitment or ability on the part of individual borrowers to fulfil their repayment commitments.



Corporate businesses, industrialists, and farmers, on the other hand, have repayment rates that are lower—8%, 17.33%, and 10.67%, respectively. Corporate enterprises have the lowest repayment rate, which may indicate greater financial instability or risk within this sector, despite accounting for a significant portion of defaults (Table 4). Even though their repayment rates are marginally higher than those of corporate businesses, industrialists and farmers still lag behind in terms of personal loans. This distribution emphasises how reliable personal borrowers are in comparison to borrowers in other sectors, and it implies that in order to increase overall repayment rates, more research into the difficulties faced by corporate and sector-specific borrowers may be required.

Table 6: Reduce the incidence of loan default

Particulars	F	%
Realizingthesecurity	23	30.67%
Demand notice	9	12%
Takinglegal action	43	57.33%
Total	**75**	**100**



The strategies used to lower the frequency of loan defaults are listed in Table 6. Taking legal action is the most often employed strategy, representing 57.33% of all responses. This suggests that the bank's main strategy for dealing with and lessening the effects of loan defaults is to regularly turn to legal action. A proactive approach to upholding loan agreements and collecting debts from defaulters is reflected in the emphasis on legal action.

In contrast, 30.67% of the respondents use realising the security, which entails taking possession of or selling collateral. "This implies that, in comparison to taking legal action, collateral recovery is an important but less common strategy." Demand notices, which are utilised by 12% of the respondents, are the least common measure, indicating that they should be used as a first step in the recovery process rather than as a complete solution. Overall, the data point to a preference for taking legal action against loan defaults in addition to recovering collateral, with demand notices being used less frequently.

Hypothesis Testing

Hypothesis 1:

H_o: The measures taken by banks do not reduce the incidence of loan defaults.

Ho_1: The measures taken by banks do reduce the incidence of loan defaults.

Chi Square of Hypothesis

Variable	0	E	(o-e)	$o\text{-}e^2$	$(o\text{-}e)^2/e$
Realizingthesecurities	23	23	0	0	0
Demand notice	9	11	2	4	0.36
Takinglegal action	43	41	-2	-4	0.09
Total	**75**	**75**	**0**	**0**	**0.45**

Computed value of x^2=Σ(o-e)2/e. Degree of freedom=(R-1) (C-1) = (2-1) (3-1) = 2 Level of significance = 0.05 X^2 distributions (2, 0.05) The table value of X^2 is 5.991.

If the computed value of X^2> than the table value of X^2 rejected the Ho hypothesis and accepted Ho_1 hypothesis but if the computed value of X^2< than the table value of x2 accepted the H_o hypothesis and rejected the Hi hypothesis, which means that there are measures that will not reduce the incidence of loan defaults.

Hypothesis 2:

H_o: Loans to individuals do not record higher rate of loan defaults.

Ho_2: The measures taken by banks do reduce the incidence of loan defaults.

Chi Square of Hypothesis

Variable	0	E	(o-e)	$o\text{-}e^2$	$(o\text{-}e)^2/e$
Industrialist	39	39	0	0	0
Agriculturist	8	10	2	4	0.4
Corporatebodies	9	5	-4	16	3.2
Individual	19	21	2	4	0.19
Total	**75**	**75**	**0**	**24**	**3.79**

Computed value of x^2=Σ(o-e)2/e Degree of freedom=(R-1) (C-1) = (2-1) (4-1) = 3 Level of significance = 0.05 X^2 distributions (3, 0.05) The table value of X^2 is 7.815.

If the computed value of X^2> than the table value of X^2 rejected the Ho hypothesis and accepted Ho_1 hypothesis but if the computed value of X^2< than the table value of x^2 accepted the H_o hypothesis and rejected the Hi hypothesis which means that there are measures that will not reduce the incidence of loan defaults.

Findings of the Study:

Numerous important insights into the lending and recovery procedures of the commercial bank are revealed by the analysis. Table 1 shows that the bank primarily makes short-term loans, which make up 58.67% of all loans given. "Long-term loans (13.33%) and medium-term loans (28%) are the next most common loan types." This distribution implies that the bank gives priority to short-term lending, maybe in an effort to reduce long-term credit risks and better manage liquidity. The inclusion of medium-term loans in a balanced manner shows that efforts are being made to meet the needs of different borrower types while still taking a cautious approach to long-term obligations.

The sectorial allocation of loans is displayed in Table 2, where 52% of loans are aimed towards industrial sectors. This indicates the bank's emphasis on assisting industries that have the potential to generate long-term economic benefits. Agricultural loans, on the other hand, only make up 10.67% of the total, which may indicate a strategic decision or factors related to risk. Additionally, the bank maintains a balanced approach by lending 12% to corporate entities and 25.33% to individuals, demonstrating a varied lending strategy to meet the needs of various industries.

Table 3 lists the difficulties in recovering loans. Finding defaulters is the biggest problem (54.66%), followed by inadequate collateral (30.67%). These results point to important logistical and risk-management difficulties in the healing procedures. The comparatively low incidence of problems pertaining to clients' incapacity to pay (14.67%) indicates that procedural and security-related obstacles are the main obstacles in addition to monetary ones.

Table 4 shows that corporate businesses account for the majority of loan defaults (61.33%), indicating that corporate loans carry a higher risk than loans to other types of businesses. Conversely, personal loans have the lowest default rate (5.33%), which may indicate that individual borrowers are more reliable with their repayments. This sector-specific default pattern emphasises how corporate loans require focused risk management plans.

The highest repayment rate (64%), found in Table 5, is for personal loans, indicating a high degree of borrower commitment in this category. The repayment rate for corporate enterprises is the lowest at 8%, indicating a need for better credit assessment and management procedures in this industry. The necessity for sector-specific strategies to improve repayment performance is further supported by the lower repayment rates among industrialists and farmers.

The most common way to deal with loan defaults, according to Table 6, is to take legal action (57.33%), which is followed by realising security (30.67%) and sending demand notices (12%). This indicates a preference for more forceful recovery strategies, like taking legal action, to address defaults, whereas demand letters and collateral recovery are employed less frequently. According to the data, while taking legal action is the primary means of dealing with defaults, a well-rounded strategy incorporating both recovery and preventive measures is also required.The study underscores the bank's strategic emphasis on industrial sectors and short-term loans, the obstacles encountered in loan recovery, and the efficacy of diverse default management tactics. A need for focused interventions to improve overall loan performance and recovery efficiency is suggested by the sector-specific analysis, which reveals the disparate risk profiles and repayment behaviours.

VI. CONCLUSION

This study provides a comprehensive examination of the commercial bank's lending practices, default rates, and recovery strategies. The findings reveal a strong inclination towards short-term loans and a significant allocation of resources to industrial sectors. The high default rates among corporate enterprises, coupled with the relatively lower repayment rates for industrialists and agriculturalists, underscore the need for tailored risk management approaches. The predominance of legal action as a recovery strategy highlights the bank's emphasis on stringent measures to combat defaults, though it also points to potential areas for enhancing preventive measures and improving collateral management.

Looking ahead, future research could delve deeper into the effectiveness of alternative recovery strategies, such as restructuring loans or offering financial counseling to defaulters. Additionally, exploring the reasons behind the high default rates in specific sectors, particularly among corporate enterprises, could provide valuable insights for refining credit assessment and monitoring processes. "Investigating the impact of economic conditions on loan defaults and repayment behaviors would also be beneficial." Further studies could focus on evaluating the success of various interventions and strategies implemented by banks to reduce defaults, thereby contributing to more robust and adaptive lending practices in the future.

Suggestions:

The following recommendations were made:

- Commercial banks should use some of the risk control procedures to guide against losses. An example of this is covenant, which is a written agreement whereby the borrower commits himself of providing specific financial statement at specific intervals during the life of the loan.

- Commercial banks should monitor its outstanding loans in order to identify promptly loans, which a borrower fails to repay as scheduled.

- Before granting loans, commercial banks should examine critically the project of financial statement provided by the customer (cash budget, income statement).

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