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RBI Working Paper Series 8

Macroprudential Regulation and Bank Performance: Evidence from India

The Reserve Bank today placed on its website a Working Paper titled "Macroprudential Regulation and Bank Performance: Evidence from India". The paper has been authored by Dr. Saibal Ghosh.

In recent times, a lot of emphasis has been placed on financial sector reforms as a means to improve the overall functioning of the sector. As it well-acknowledged, such reforms have encompassed a significant gamut of measures, including lowering of statutory reserve requirements, deregulation of interest rates, introduction of measures relating to income recognition, loan classification and provisioning, allowing more liberal entry of foreign banks and diversifying the ownership base of state-owned banks. The evidence emanating from empirical research is admittedly mixed. The existing literature tends to look at each macroprudential measure in isolation, thereby ignoring the effect of these measures in totality on bank performance.

In this context, the paper investigates how various measures of macroprudential regulation affect the performance of the banking sector. More specifically, employing bank-level data across various ownership categories for the period 1992-2012, the paper considers the impact of three major dimensions of macroprudential regulation – capital adequacy ratio, provisioning norms and loan classification requirements – on the performance of the Indian banking sector. To assess the impact, the author employs four indicators: return on asset (RoA) as the profitability measure, net interest margin (NIM) as the measure of economic efficiency, Z-score as the measure of bank stability and finally, advances growth (Gr_Advances) as a measure of bank business.

The major findings of the paper can be summarised as follows:

- Banks with greater retail dependence have higher profitability and margins. In the baseline specification, a 10 per cent increase in retail dependence improves RoA by nearly 0.3 percentage points. One reason for this could be the low (or negligible) cost of such deposits, which enables banks to earn higher margins and profitability on such funds.

- Bigger banks appear to exhibit greater stability. As well, credit growth is slower for big banks, suggestive of the fact that smaller banks increase credit at a faster pace to gain market share.

- When we include bank ownership, it is observed that as compared to domestic private banks, foreign banks have lower credit growth and stability. The effect is quantitatively important, indicating that the average foreign bank has a credit growth that is 0.08 percentage points lower as compared to an average domestic private bank.

- Next, the analysis examines whether such differentials between state-owned and private banks are driven by macroprudential measures; it finds strong support for this hypothesis.

The Reserve Bank of India introduced the RBI Working Papers series in March 2011. These papers present research in progress of the staff members of the Reserve Bank and are disseminated to elicit comments and further debate. The views expressed in these papers are those of authors and not those of the Reserve Bank of India. Comments and observations may kindly be forwarded to authors. Citation and use of such papers should take into account its provisional character.

Sangeeta Das
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