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The Nexus between Liquidity Creation and Capital : Evidence from Indian Banks

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Abstract

This study explores the interrelationship between liquidity creation and capital for scheduled commercial banks operating in India during 2005-2019. Liquidity creation construct is developed following the approach of Berger and Bouwman(2009). Using a simultaneous equation model with GMM estimator, a negative bi-directional relationship is observed between the two, which suggest higher capital will decrease liquidity creation and vice versa. This relationship holds for different ownership structures as well. This study highlights how regulators and policymakers over-emphasize the risk-minimizing role of capital and overlook the trade-off between financial stability and output. It is also observed that when banks face illiquidity, they prefer deposits over capital because they are considered to be stable and better accessible.

JEL Code : G01, G18, G20, G21
Keywords : Banks, Liquidity, Capital, Crisis, GMM, SCBs, Econometric, India

I. Introduction

BANKS ARE INTEGRAL institutions in the economy. Liquidity creation is a crucial function of a bank.When a bank transforms customer deposits into loans, liquidity is created. Liquidity creation has positive effects on real economic output and increases the credit flow in the economy(Berger and Sedunov, 2017; Diamond and Rajan, 2001).However, by holding illiquid assets and offering ready access to the deposits, bank incurs liquidity and withdrawal risks. Since there are chances of asset-liabilities mismanagement, for example, situations like unexpected withdrawals by customers will impel banks to dispose of assets at lower prices. The subprime crisis is the

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of "financial fragility crowding-out hypothesis" raises a challenge for the policymakers in terms of choosing between financial stability and delivering output. Tightened capital norms will hamper liquidity creation, whereas holding higher capital ensures solvency. Policymakers should be mindful of such tradeoff while implementing stringent capital norms. Incomplete deposit insurance makes depositors more vulnerable. To make sure their safety and maintain stability in the system, RBI has been strict towards the implementation of capital ratios.RBI has stipulated stricter capital norms. Such stringency may strengthen solvency but may restrict the liquidity creation process.India is highly dependent on the banking sector, which makes deposit mobilization easier for banks. Banks prefer deposits over capital when they are faced with higher illiquidity because they are considered to be more stable and accessible. Hence banks are not strengthening their capital ratios according to the Basel norms. Some leniency is recommended in capital adequacy norms because it is hampering the liquidity creation process.

Notes

1. Based on RBI's reclassification,IDBI bank has been treated as private sector bank throughout the study period after LIC acquired 51% stake in it.
2. Earlier the deposit coverage of banks operating in India was Rs.1 lakh, this amount has increased from Rs.1 lakh to Rs.5 lakh with effect from 4th February 2020.

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