Capital and Risk in Indian Commercial Banks: Issues and Evidences

Abstract

This study tries to examine the various issues related to bank capital and risk of Indian Commercial Banks during the period 1996-97 to 2013-14. Employing the Generalized Method of Moments technique in a Granger Causality framework we find that the interrelationship among bank capital and risk is bidirectional and inverse and regulatory pressure, bank size, profitability, loan to asset ratio, loan growth, business cycle, inflation and interest rate are the major determinants of bank capital and risk in India. The adjustment speed to target capital buffer is around 53% and the speed of adjustment is higher for the public sector banks. The exogenous factors like liquidity creation and competition also affect bank capital and risk decisions. Liquidity creation in banks reduces the bank capital ratio and increases the level of bank risk. The results reveal that monopolistic competition prevails in Indian banking sector and there is a bidirectional relationship between competition and bank capital ratio. We also find that risk of the commercial bank decreases with the increase in competition among banks. The results are robust across the different types of banks classified on the basis of ownership, bank size, capitalization and time periods. These findings have the implications for the bank managers and policy makers to formulate an appropriate policy for the capital and risk management of the commercial banks in India.

Keywords: Commercial Banks, Bank Capital, Risk, Liquidity Creation, Competition, Generalized Method of Moments, Granger Causality.