

Assessment and Evaluation of Stress Management Performance – A study on Indian Banks

Abstract

Liberalization has increased the competitive pressure in banking sector, compelling banks to take more risk in order to maintain their profit margin and market share. Empirical evidences suggest that excessive risk-taking behavior is detrimental for solvency and systemic stability. The Indian banking sector has undergone multiple reforms aimed at improving resilience of banks. Despite improvement in their solvency, stress continue to remain high due to shortage of low-cost liquidity. Growing interconnectedness among banks fuels rapid contagion of default and transmission of panic-driven behaviour by depositors/borrowers during periods of uncertainty. The study devises a cost-based measure to capture stress stemming from various dimensions of banks operations and examines its determinants. Understanding the link between stress and its determinants would assist effective policymaking to enhance stability of banks. The thesis constructs an interbank network structure and examines its attributes under different stress scenarios. The identification of major stress emitting banks and spillover of stress enables regulator to design suitable policies to lower the interconnection and contain stress. The thesis analyses the performance-stability nexus in banks by incorporating qualitative performance constructs like governance quality and customer orientation. Using system GMM estimator, the study identifies the performance constructs for managing banking stress. These findings are augmented with inputs from expert judgement through DEMATEL analysis to provide credibility to our findings. The analysis of dynamic interaction between performance and stress along with their response to shock over time, can guide useful managerial response to enhance profitability and promote stability.

The empirical findings of the thesis advocate proactive monitoring of capital adequacy and credit screening practices during economic upcycle for reducing procyclicality of bank lending and enhance stability. Systemically Important Banks (SIBs), being the major emitters of stress in the interbank network, should be subjected to stricter supervision of their liquidity, solvency and assets quality. Banks should focus on qualitative performance paradigms such as Governance Quality and Customer Orientation to achieve greater long-term stability. As higher liquidity is often mis-utilized by banks to increase leverage, implementation of additional liquidity buffer during good times can acts as an effective countercyclical regulatory measure for improving stability of banks.

Keywords: Stress, Solvency, Liquidity, Customer Orientation, Governance, Interconnectedness, GMM, Panel VAR, DEMATEL