

Liquidity Risk in Commercial Banks in India

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Liquidity risk is a crucial factor in the business of commercial banking. At the root of the 1997 Asian crisis was the failure of banks to meet liquidity risk arising from differences in currency composition of their assets and liabilities. Diamond and Dybvig (1983), Diamond (1997), Diamond and Rajan (1999) have considered liquidity issues centrally important in theory and functioning of commercial banks.

Looked from this perspective, maturity transformation is an important aspect of financial intermediation. Providing deposit insurance is a well accepted measure that enables banks to provide liquidity by maintaining public confidence in the banking system. Similar would be the effect on public confidence where banks are owned by government. With moves towards competition and deregulation, operating in market oriented business environment becomes crucial which makes risk management an important task. The process of financial deregulation leads to increased incidence of market risks such as currency risk and interest rate risk. Moreover, as clients of commercial banks face competitive business environment, their exposure to credit risk too will increase. In such a situation, maintaining liquidity risk within manageable limits becomes extremely important. Liquidity risk would in fact represent aggregate incidence of market and non-market risks.

In a deregulated interest rate scenario, market interest rates would command a term premium and credit risk premium. In such a scenario, banks would face a trade off between liquidity and profitability. Different banks may choose different strategies depending on their risk preferences and business/client profiles.

The paper seeks: (a) to assess the liquidity profiles of commercial banks in India and the impact of financial sector liberalisation on it; (b) to study liquidity profiles of different categories of commercial banks and to find whether such differences have any impact on their business strategies as reflected in pattern of deposit rate or composition of portfolio etc.

The paper, using liquidity gap reports recently included in the published accounts of commercial banks, finds significant differences in liquidity profiles of different categories of commercial banks and these could be related to different market segments they operate, their management styles and risk appetite. The differences in risk profiles are reflected in NII and net profit to assets ratio. The analysis reveals that any measure of liquidity risk in actually existing banks should be able to distinguish different credit risks faced by these banks.

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