Available online @ www.iaraindia.com
RESEARCH EXPLORER-A Blind Review & Refereed Quarterly International Journal
ISSN: 2250-1940 (P) 2349-1647 (O)
Impact Factor: 3.655 (CIF), 2.78 (IRJIF), 2.62 (NAAS)
Volume VIII, Issue 28
July-September 2020
Formally UGC Approved Journal (63185), © Author

ANCHOR EFFECTS OF MONETARY POLICY RATES ONTHE BANK'S PERFORMANCE

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Abstract

Financial sector reforms are happening continuously to contribute to economic growth and development. Mergers are taking place between banks, either public or private banks. Commercial banks play a significant role in controlling the price liquidity in the economy by collecting large numbers of small amounts and giving credit to those who are in need of money. The institute which regulates the banking system in India is the Reserve Bank of India, which is the central/apex bank of India. The central banks have quantitative instruments through which it regulates the money supply or price liquidity in the economy. When there is a change in the monetary policy rates, banks should adopt the new announced monetary policy rates in their performance. Central bank either choose expansionary or contractionary monetary policy according to the economic situation. The study concentrates on whether banks are getting affected by a regular change in monetary policy rates. The monetary policy committee will meet bi-monthly and decide to change the monetary policy rates or not. The alteration in monetary policy rates is directly applied of the banks in India. The study also concentrates on public and private sector banks in India. There are various performances of commercial banks like profitability, credit lending performance, financial performance, operating performance, and so on. Profitability performance of both public sector banks and private sector banks and their impact on a change in monetary policy rates. Coming to monetary policy rates Cash Reserve Ratio, Statutory Liquidity Ratio, Repo Rate, Reverse Repo Rate, Bank Rate are included as independent variables, and Profit After Tax is considered as a dependent variable. Regression analysis befits for this study to look for the impact on the profitability of commercial banks in India.

Keywords: *Financial sector reforms, Reserve Bank of India, Commercial Banks, Monetary policy rates, Public sector banks, Private sector banks, Profitability.*

INTRODUCTION

Central Bank

India is one of the fastest-growing economies in the world, with a population of over 1.354 billion (Ministry of Statistics and Programme Implementation & UN reports 2017-18). It is also stated as the seventh-largest nation in the world. India has become the hub for global investment. Various factors influence and control the Indian economy. One of the significant factors is the RBI, which is also one of the oldest and most reputable institutions behind the success of our Indian economy. Control in Balance of Payment, FOREX reserve, capital and money market and other sectors of the India economy are all happening because of the strong backbone of the RBI.

The bank which governs the entire banking system, including the money market, is the Central bank. The main and primary function of the central bank is to assist the government in formulating economic policy, controlling the money market, and also bank credit. According to some bankers and economists, "a central bank is a bank whose essential duty is to maintain the stability of the monetary standard."

"The central bank is a banking system in which a single bank has either a complete or a residual monopoly of note issue."

-Decock

Monetary policy:

It is the process by which the monetary authority of the country, Usually the central bank regulates the money supply in the economy by its control over interest rates to sustain price stability and attain high economic growth. The objectives of monetary policy, which is governed by the central bank, i.e., The Reserve Bank of India, are to maintain price stability, full employment, economic growth, and Balance of Payment.

The monetary policies are of two types, and they are Expansionary and Contractionary policy. Expansionary monetary policy is when a central bank uses its tools to expand the economy by increasing the money supply and sinking interest rates, which increases aggregate demand, and that boosts economic growth as measured by GDP (Gross Domestic Product) in India. It helps during the time of recession. And Contractionary monetary policy is a set of tools that slow down the growth rate of the economy to prevent it from stickiness; these tools include the credit flow in the marketplace, interest rate, and currency exchange. It helps during the time of inflation.

Commercial Banks

Commercial banks are indeed the most significant credit institutions in the economy in the business of lending and borrowing money and credit creation. Traditionally, commercial banks came into being for commercial purposes. The commencement of modern banking is the result of a commercial bank. Professor Roger defines that "the banks which deal with money and money's worth with a view of earning a profit is known as a commercial bank." The commercial banks have the primary objective to collect savings or idle money from the public by providing a specified rate of interest, and the same money is lent to the public at a higher rate of interest. The other objectives are to create awareness about savings amongst the people, to concentrate on profit maximisation, to expedite investment, to build capital through savings, to maintain economic stability, to extend service to customers, to assist the government for trade and business and socio-economic development, to extend assistance and suggestion to the government on economic issues.

"Bank is an institution that collects money from those who have in spare or who are saving it out of their income and offer this money out to those who require it."

-Crowther

"A banker is one who, in the regular course of business, honours cheques drawn upon him by persons for and for whom he accepts money on the current account."

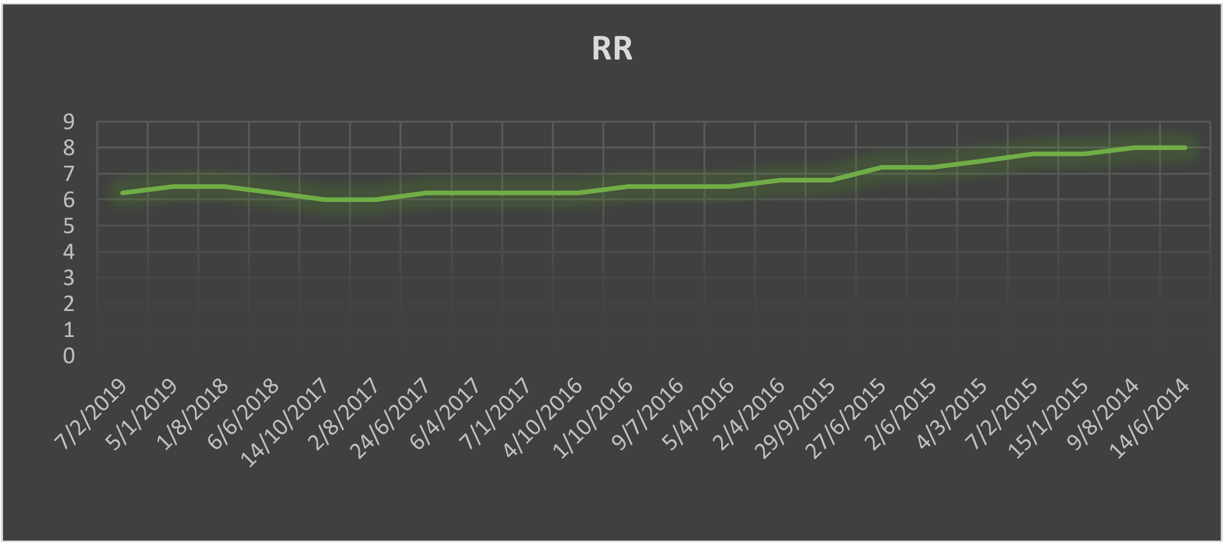
-Professor Hart

Review of the operation of monetary policy instruments:

- **Repo Rate**: Repo rate is the interest rate at which RBI lends to its clients generally against government securities. Reduction in the Repo rate helps the commercial banks to get money at a cheaper rate, and an increase in the Repo rate discourages the commercial banks from getting money as the rate increases and becomes expensive.

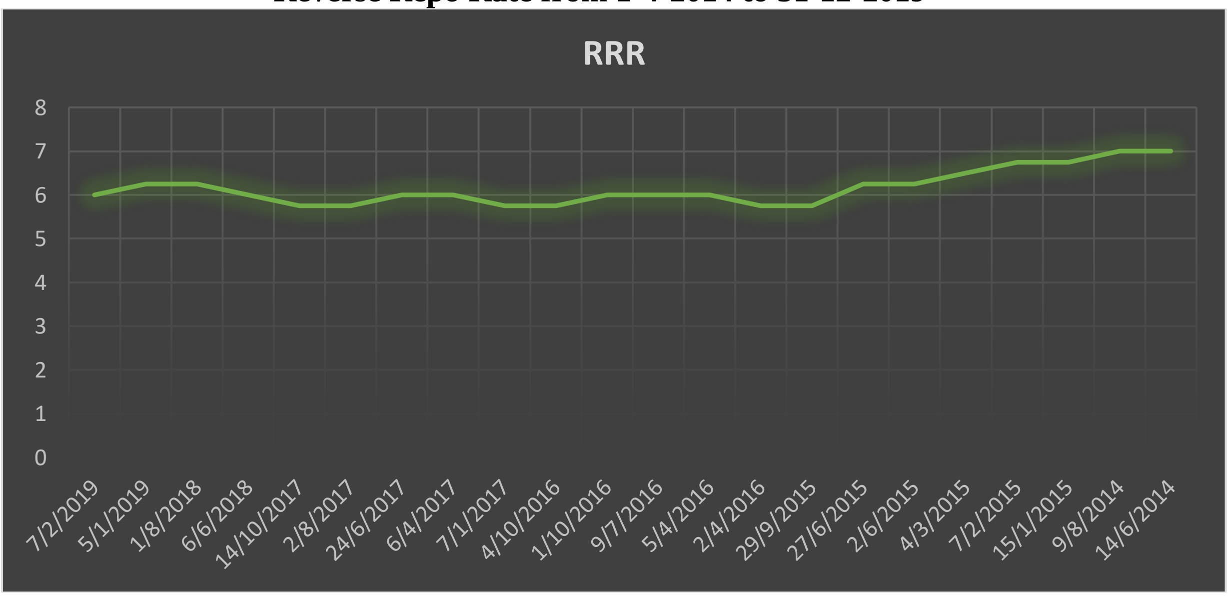
Chart 1

Repo Rate from 1-4-2014 to 31-12-2019



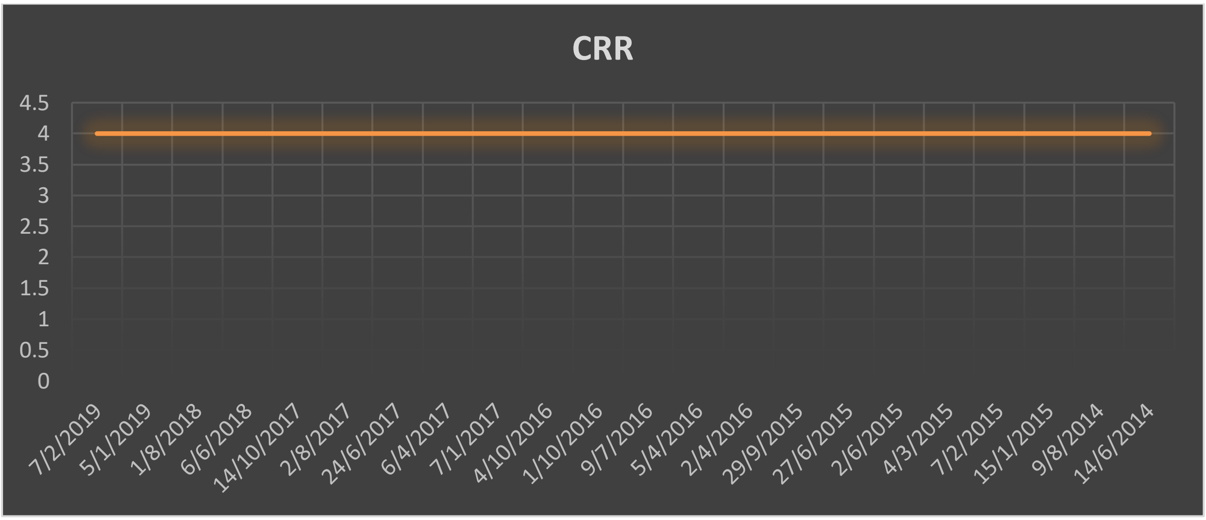
- **Reverse Repo Rate**: Reverse Repo Rate fixed by the monetary policy committee by which RBI borrows money from commercial banks. The increase in the Reverse Repo Rate will increase the cost of borrowing and lending of the banks, which will discourage the public from borrowing money and will encourage them to deposit.

Chart 2
Reverse Repo Rate from 1-4-2014 to 31-12-2019



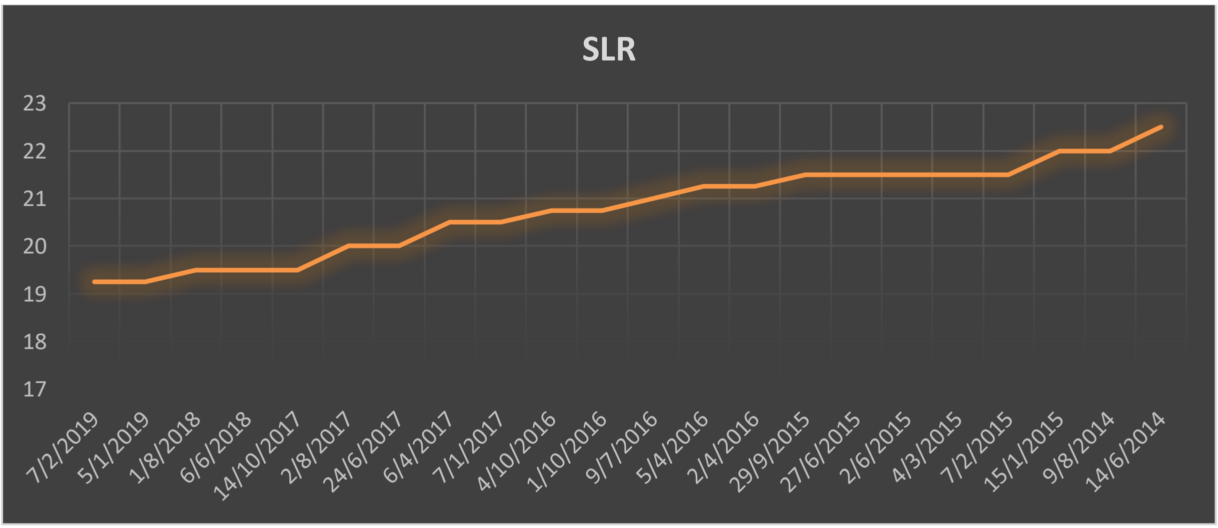
- **Cash Reserve Ratio**: The portion of the total bank's deposit mandated by the central bank to be preserved with the central bank in the form of cash, that portion is called cash reserve.

Chart 3
Cash Reserve Ratio from 1-4-2014 to 31-12-2019



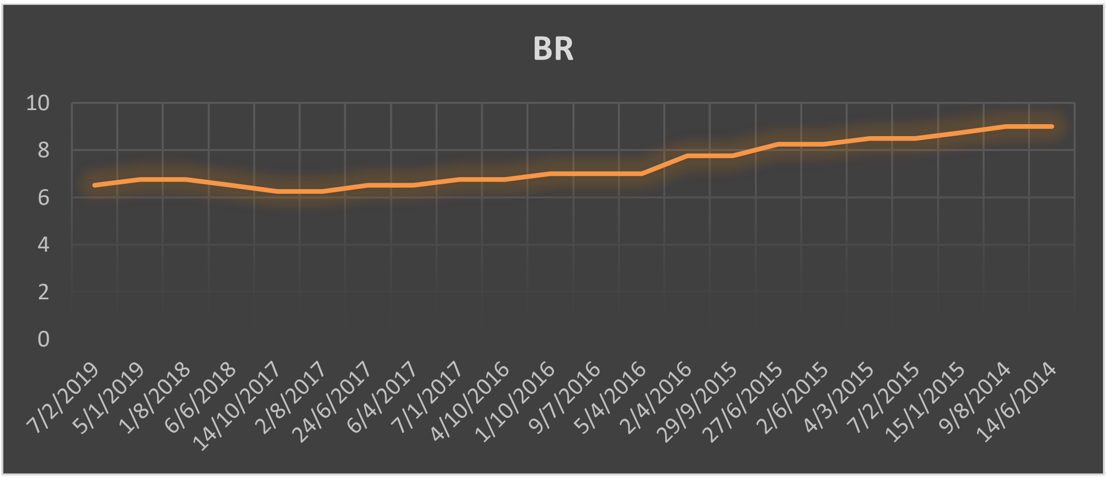
- **Statutory Liquidity Ratio**: The minimum reserve requirement that has to be preserved by the banks in India with itself. The percentage at which the banks maintain the minimum reserve is called Statutory Liquidity Ratio. The word 'statutory' says that retaining the reserve is mandatory and legally required.

Chart 4
Statutory Liquidity Ratio from 1-4-2014 to 31-12-2019



- Bank Rate: The Reserve Bank of India sets an interest rate(is also the lowest rate) at which it lends money to the banks in India. This rate affects the interest rates that are then charged to the customers by the banks.

Chart 5
Bank rate from 1-4-2014 to 31-12-2019



The monetary policy deals with the primary function of the supply of money in the market, observing that it should not cause the circumstances of inflation and recession. The RBI being the central authority of monetary policy uses tools to regulate the inflow and outflow of the money in the economy. Monetary policy plays a vital role in economic growth, and its instruments play an important role in adjusting the financial condition according to the current economic situation.

State Bank of India (SBI)

The State Bank of India is an Indian public sector banking and financial institution. It is a government corporation and also a regulatory authority, headquartered in Mumbai, Maharashtra. SBI has over 24000 branches in India. In the financial year 2012–13, the revenue of SBI was ₹2.005 trillion (US$29 billion), out of which domestic operations contribution was 95.35% of revenue. Similarly, domestic operations contribution was 88.37% of total profits for the same financial year.

Under the Pradhan Mantri Jan Dhan Yojana regarding financial inclusion launched by Government in August 2014, SBI held 11,300 camps and also opened around 3 million accounts by September, which included 2.1 million accounts in a rural sector and 1.57 million accounts in the urban region.

ICICI bank

ICICI (Industrial Credit and Investment Corporation of India) Bank Limited is
an Indian multinational banking and finan cial services company, having its headquarter in Mumbai, Maharashtra with its registered office in Vadodara, Gujarat. As of 2018, ICICI bank stands second largest bank in India in terms of assets and market capitalisation. It offers an extensive range of banking products and financial services for corporate and retail customers through a variety of distribution channels and specialised subsidiaries in the areas of investment banking, life, non-life insurance, venture capital and asset management. The bank has a vast network of 4882 plus branches along with 15,101 ATMs across India and has an existence in 17 countries including India. ICICI Bank offer products and services like online money transfer & tracking service, loans,

automated lockers, credit card, debit card and digital wallet.

Statement of the problem

The problem of the study is to identify how the profitability of the commercial bank will impact when there is a change in monetary policy rates. The monetary policy rates will change as and when required, according to the situation. But how the banks will react and face the rate change is a big question. Whenever the rate changes, the bank is the primary factor that is most affected, and how it will tackle the move is a big challenge. When there is a requirement of money to the economy, the rates will be reduced and vice versa.

Hence, the RBI should also take into consideration the effect of a rate change on commercial banks in India and take steps to implement the new rates. The banks should also get ready and take precautionary measures to safeguard from sudden rate changes in monetary policy.

Review of related literature

(Minakshl Malhotra and Glan Kaur 1992) The attempt has been made here to measure the impact of the various instruments of monetary policy on the profitability of the commercial banks quantitatively, and it resulted that the monetary policy has been contributing negatively to the burning topic about the declining profitability of the commercial banks in India.

(Rao 2006) The Reserve Bank would continue to keep a constant watch on the domestic and external situation. Monetary policy is guided by the objective of the provision of adequate liquidity to meet credit growth and support demand for investment in the economy while monitoring the movements carefully at the price level. The policy stance remains to be one of the favourites for a soft and flexible interest rate environment within the context of macroeconomic stability.

(Kaushal 2011) The policy changes impact the commercial banks' interest profitability, but when the policy tightens its stance, commercial banks have enough flexibility to readjust their lending rates and deposit rates to narrow down the impact on its profitability due to hike in policy rates. Banks work in tandem to the monetary policy's stance to bring out the desired result in the economy.

(Abah 2015) The proxies used for monetary policy are the interest rate and money supply, while Profit before Tax was used as a representation of commercial banks' performance. The result showed a positive relationship between bank profit and monetary policy. The study recommends that interest rate policy should be taken care of by the monetary authority in a way that is welcoming to loan advancement in the country.

(Udeh 2015) Monetary policies being an external factor to the banks, the tools could act as a militating or mitigating factor in boosting banks' profitability. The way and manner these aspects are applied to banks vary from one country to the other and have a traceable relationship to the state of the particular country's economy. The study examined the impact of cash reserve ratio, liquidity rate, interest rate, and minimum rediscount rate on the profit before tax of zenith Bank Plc. It was found that a minimum rediscount rate had a great relationship with the profitability of Zenith Bank Plc. It also had a significant and positive impact on the profitability of the bank. The other factors did not have preferences considerable effect on the profitability of the bank.

(Claudio borio 2015) They found a positive relationship between the level of short-term rates and the slope of the yield curve ("interest rate structure," for short), on the one hand, and bank profitability - Return on Assets on the other. It suggests that the positive impact of the interest rate structure on net interest income dominates the negative one on loan loss provision and non-interest income. The findings of the study have inferences for long-term rates being very low for very long periods. It is also expected to be temporary, as evaluation gains only have a one-off impact on profitability.

(Thanh Nhan Nguyen 2017) When there is a change in monetary policy, change directly affects the bank's profitability. They briefed that the banking profit's determinants also include Credit Growth and Liquidity, and also they are the primary internal drivers of banking profit. Moreover, the macroeconomic factors, including economic growth and inflation, are shown to have a significant influence on the banking system's performance.

Objective

The purpose of the study is to analyse and understand how the profitability of State Bank of India (Public sector bank) and ICICI bank (private sector bank) are getting affected by the change in monetary policy rates. The monetary policy rates are Cash Reserve Ratio, Statutory Liquidity Ratio, Bank Rate, Repo Rate and Reverse Repo Rate. And also to determine which sector's profitability (public sector or private sector) is getting affected more by the change in monetary policy rates.

Hypothesis

H_{A1}: Cash Reserve Ratio has a significant effect on the profitability of SBI and ICICI bank.

H_{A2}: Statutory Liquidity Ratio has a significant effect on the profitability of SBI and ICICI bank.

H_{A3}: Bank Rate has a significant effect on the profitability of SBI and ICICI bank.

H_{A4}: Repo Rate has a significant effect on the profitability of SBI and ICICI bank.

H_{A5}: Reverse Repo Rate has a significant effect on the profitability of SBI and ICICI bank.

EMPIRICAL STUDY

Cash Reserve Ratio, Statutory Liquidity Ratio, Bank Rate, Repo Rate and Reverse Repo Rate of monetary policy have been assumed to be independent variables in the regression equation to analyse the impact on profitability. The duration of the study is from April 2014 to March 2019, i.e., for five years. Thus the regression equation to be projected for the purpose takes the following form.

Bank's Profit = $\beta_0 + \beta_1 CRR + \beta_2 SLR + \beta_3 BR + \beta_4 RR + \beta_5 RRR$

The results of the estimated regression equation are presented in Table 1 and Table 2.

Table 1

Estimation of regression of independent variables of SBI (Regressed independently)

Intercept	SLR	BR	RR	RRR	R	R Square	D-W	f-stat
-77.403	3.923 (3.674)	_	_	_	0.905	0.818	3.263	13.495
-26.608	_	4.143 (2.795)	_	_	0.850	0.723	2.955	7.812
-37.072	_	_	6.041 (2.222)	_	0.789	0.622	1.762	4.936
-28.416	_	_	_	5.180 (1.251)	0.586	0.343	1.612	1.566

Information In the parentheses are the t values

Table 2
Estimation of regression of independent variables of ICICI bank.
(Regressed independently)

Intercept	SLR	BR	RR	RRR	R	R Square	D-W	f-stat
-105.445	5.851 (5.237)	_	_	_	0.949	0.901	1.936	27.421
-24.607	_	5.854 (2.245)	_	_	0.792	0.627	1.628	5.042
-25.511	_	_	6.073 (1.165)	_	0.558	0.311	1.173	1.356
-24.896	_	_	_	6.516 (1.050)	0.518	0.269	0.869	1.103

Information In the parentheses are the t values

In table-1, the correlation between the monetary policy rates and profitability of State Bank of India (public sector bank) is very high in case of statutory liquidity ratio, in descending order next comes bank rate and repo rates. However, the correlation of profitability of SBI and reverse repo rate is medium but not low. Even the R-square value of statutory liquidity ration is approximately 82 per cent (81.8%) which shows there is a strong significance relationship. The R-square value of bank rate and repo rate shows a significant impact on the profitability of the State Bank of India. Even the Durbin-Watson test says that the autocorrelation between statutory liquidity ratio and bank rate with the profitability of State Bank of India is negative, and the relation between repo rate and reverse repo rate with the profitability of State Bank of India is positive.

In table-2, the correlation of between the monetary policy rates and profitability of ICICI bank (private sector bank) is very high in case of statutory liquidity ratio, in descending order next comes bank rate and repo rates. However, the correlation of profitability of ICICI bank and reverse repo rate is medium but not low. Even the R-square value of statutory liquidity ration is ninety percent (90%) which shows there is a strong significance relationship. The R-square value of bank rate and repo rate shows a significant impact on the profitability of the ICICI bank. Even the Durbin-Watson test says that the autocorrelation between statutory liquidity ratio and bank rate with the profitability of ICICI bank is negative, and the relation between repo rate and reverse repo rate with the profitability of State ICICI bank is positive.

When the impact on both SBI and ICICI bank are observed, the private sector bank (ICICI Bank) is responding fast when compared to the public sector bank (SBI). In the case of correlation, private bank's numbers are higher than public sector bank. Same in case of R-square and Durbin-Watson test, the private sector bank's are responding faster than public sector banks.

Conclusion

The expectations are entirely satisfactory in the overall monetary and macroeconomic situations in India. The improvements are necessary for the financial sector reforms in India. On the other hand, the Reserve Bank of India would continue to keep a steady and strict watch on domestic and exterior situations. To regulate the liquidity, inflation, and movements in the price level, the Reserve Bank of India should also consider qualitative tools along with the quantitative tools. The qualitative tools will not impact the profitability of commercial banks as it focuses only on credit ceiling and credit control. Hence, there will also be fewer fluctuations in the interest rate of commercial banks in India. The stance on the monetary policy continues to be one of the best preferences for a soft and flexible interest rate environment within the framework of macroeconomic strength.

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