

Regulatory Credit Supply Shocks, Reallocation, and Real Economic

Outcomes

Executive Summary

This paper studies how regulatory interventions targeting financially weak banks affect credit allocation and real economic outcomes. We examine the Reserve Bank of India's (RBI) Prompt Corrective Action (PCA) framework, a structured early detection and supervisory mechanism designed to restore bank health by imposing escalating restrictions on undercapitalized banks. Using staggered bank-level entry into PCA, we analyze whether regulatory enforcement reduces risky lending, reshapes credit allocation across firms, and ultimately influences firm-level and industry-level economic performance. During our sample period (2013–2019), banks admitted to PCA accounted for nearly 15.6 percent of total bank lending, making the intervention quantitatively significant for the broader economy.

We combine the universe of collateralized corporate loans from the Ministry of Corporate Affairs with firm-level financial data from CMIE Prowess and bank balance sheet information from the RBI. Exploiting variation in the timing of banks' entry into PCA, we implement a staggered difference-in-differences design and conduct extensive robustness checks, including an instrumental variables strategy based on regulatory threshold breaches. Across specifications, we find that PCA admission leads to a significant contraction in overall lending by treated banks. Lending falls disproportionately to high-risk firms, defined using pre-treatment interest coverage ratios.

At the firm-creditor level, where we control for borrower fixed effects to isolate credit supply from demand factors, we show that the decline in lending is driven by the supply channel. Using stricter definitions of "high risk" firms, we confirm that PCA significantly reduces lending to financially distressed firms that rely on continued bank support. These findings contrast with prior Indian bank clean-up measures, such as the Asset Quality Review, which did not successfully curb high-risk lending among weak banks.

We find little evidence that high-risk firms exposed to PCA are able to substitute lost bank credit with borrowing from non-bank financial institutions or shadow banks. As a result, exposed high-risk firms experience persistent declines in real outcomes, including sales, capital work-in-progress, net fixed assets, and wage expenditures. In contrast, low-risk firms in industries more exposed to PCA receive relatively more credit and expand investment and employment-related expenditures. These patterns are consistent with a reallocation of credit and productive resources from high-risk to low-risk firms.

At the industry level, we document modest improvements in productivity in more exposed sectors. Measures of labor productivity, capital productivity, and total factor productivity show gains following the reallocation of credit. There is a fall in prices in exposed industries. The results align with the "zombie congestion" and creative destruction literature: when credit to weak firms is curtailed, healthier firms can expand, leading to more efficient resource allocation and higher aggregate productivity.

Finally, we also find evidence of a deterrence channel, whereby even banks under milder supervisory thresholds reduce high-risk lending to avoid stricter regulatory action. Taken together, the evidence suggests that structured early intervention, rather than delayed recognition of bad assets alone, can meaningfully reduce credit misallocation, curb zombie lending, and improve real economic performance with limited collateral damage to healthier firms.