

## **Abstract**

This is the first empirical study to examine the impact of off-balance sheet banking activities on monetary transmission mechanism via the bank lending channel and hence, it contributes to both off-balance sheet banking and monetary transmission literature. Using income statement and balance sheet data for a sample of South Asian commercial banks within panel regression framework, this study reveals that off-balance sheet activity reduces the effectiveness of bank lending channel of monetary transmission. Thus, banks having more exposure to off-balance sheet activity could insulate their loan supply and they are more sheltered against a monetary policy shock. Based on sub-sample analyses, this study also suggests that highly liquid and well-capitalised banks are able to protect their lending activity from the effects of monetary policy. Focusing on the Sri Lankan context exclusively, this study also finds that increased off-balance sheet banking in Sri Lanka is a moderating factor to the effectiveness of monetary transmission via domestic, large and also poorly-capitalised banks. This buffering effect of off-balance sheet activity raises important policy issues for monetary authorities particularly with regard to the definition of monetary aggregates and evaluation of monetary policy effectiveness.

**JEL Classification:** E44; E5; G21; G32

**Key Words:** Financial disintermediation; Off-balance sheet banking; Monetary transmission; Bank lending channel; Panel estimates; South Asia; Sri Lanka