An Impact of Credit Risk Management on Financial Performance: Evidence from Licensed Finance Companies in Sri Lanka

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Abstract

The sustainable development of any country in today's world heavily relies on the stability of financial intermediaries' performance. In Sri Lanka, Licensed Finance Companies (LFC) serve as the primary financial intermediaries. Credit risk, stemming from borrowers' inability to repay loans or fulfill contractual obligations, stands out among the various risks faced by LFCs, playing a crucial role in determining their financial performance. While numerous previous studies have explored the impact of credit risk management on LFCs' financial performance, there is a scarcity of research specifically comparing such impacts within the Sri Lankan context. Therefore, this study seeks to bridge this empirical gap by investigating the influence of credit risk management on the financial performance of LFCs. Additionally, the research assesses the level of credit risk management practices in the Sri Lankan LFC sector using the CAMEL rating method. The sample includes 26 LFCs, and the study spans from 2018 to 2022. The panel regression model is employed for estimation, and data is gathered from published annual reports. Utilizing EViews Statistical software, the analysis includes descriptive analysis, correlation, and regression analysis. The study's results, indicating the best sector of credit risk management based on the lowest CAMEL composite ranking, offer valuable insights for investors to make more informed and profitable investment decisions with lower risks. Furthermore, the study concludes, through regression analysis, that both asset quality and capital adequacy significantly impact the performance of LFCs."

Keywords: Credit Risk, CAMEL Rating Method, Financial Intermediaries, License Finance Companies (LFC), Financial Performance