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Impact of Credit Risk on Financial Performance of Domestic Commercial Banks in Sri Lanka

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Abstract

Introduction: The banking sector is an important industry that needs to be secured, as its failure is bound to negatively impact the country's whole economy. The current study examines the impact of credit risk on the financial performance of 12 Sri Lankan domestic commercial banks.

Methodology: This study harnessed advanced panel data techniques to measure the impact of credit risk on financial performance within the context of domestic commercial banks in Sri Lanka from 2012 to 2021. Three distinct estimators pooled ordinary least squares, fixed effects, and random effects models were employed to rigorously examine the impact of credit risk on key financial performance indicators, specifically, return on assets (ROA) and liquidity, using STATA software.

Findings: These findings on a fundamental feature of the banking landscape, revealing a negative association between credit risk and financial performance, notably liquidity and return on assets (ROA), are significant. The demonstrated inverse link highlights the significant impact that non-performing loans (NPLs) can have on the liquidity and profitability of the commercial banks under consideration. Non-performing loans, which pose a high credit risk, hurt a bank's ability to maintain optimal liquidity levels. The negative correlation in liquidity shows that as the load of NPLs grows, banks may face difficulties paying short-term financial obligations. Furthermore, the negative impact extends to return on assets, a fundamental criterion for assessing commercial banks' profitability. The negative relationship between credit risk and ROA suggests that banks' total profitability decreases when non-performing loans increase. This is consistent with recognized financial concepts, showing that a rising proportion of non-performing loans can reduce earnings provided by assets held by banks.

Conclusion: The results facilitate policymakers to prepare better performance targets and enable bank managers to allocate capital more efficiently. Further, the results of this study can be used for the requirements of future researchers and academic students.

Keywords: Non-Performing Loans, Statutory liquid assets, Return on assets, Domestic commercial banks