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The Impact of Credit Risk on Financial Performance of Listed Licensed Commercial Banks in Sri Lanka

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Abstract

Purpose: Based on the current crisis in Sri Lanka credit risk appears to be the biggest threat to banks. The substantial portion of non-performing loans on the bank's balance sheet affects its performance and reduces its profitability. This paper aims to analyze the impact of credit risk on the financial performance of listed commercial banks in Sri Lanka.

Methodology: The secondary data from 10 commercial banks in Sri Lanka were collected for the sample period of 2013-2022 referring to their annual reports. Return on Asset (ROA) and Return on Equity (ROE) were used as proxies for financial performance indicators while Non-Performing Loans (NPLs), Capital Adequacy Ratio (CAR), and Loan Loss Provision (LLP) were used as credit risk indicators. The study employed descriptive statistics, panel regression analysis, and correlation analysis for data analysis.

Findings: The study shows that non-performing loans (NPLs) demonstrated a significant impact on ROA and ROE.

Conclusion: The practical implications of the study suggest that banks should aim to maintain adequate capital reserves, implement effective risk management strategies, consider firm size, monitor financial leverage, and engage in continuous research and regulatory compliance. To thrive in a dynamic financial landscape, commercial banks should stay updated on the latest research and industry best practices.

Keywords: Return on Asset, Return on Equity, Non-Performing Loan, Loan Loss Provision, Capital Adequacy Ratio.