The Impact of Capital Adequacy Ratio on Bank Risk-Taking Behavior: Evidence from Local Commercial Banks in Sri Lanka

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Abstract

This study investigates the relationship between capital adequacy ratio (CAR) and default risk (DR) among local commercial banks in Sri Lanka. Utilizing a panel dataset spanning from 2012 to 2022, the study employs a random effects regression model to analyze the impact of CAR on DR, controlling for bank profitability (BP), bank size (BS), and bank interest rate (I). The findings reveal a complex relationship between CAR and DR, suggesting that a higher CAR may not always lead to a lower level of default risk. This counterintuitive finding challenges the conventional understanding of CAR as a standalone measure for mitigating risk. The study also identifies a positive and statistically significant relationship between BS and DR, emphasizing the need for enhanced risk management practices, particularly for larger banks.

Keywords: Capital Adequacy Ratio, Default Risk, Bank Profitability, Bank Size, Bank Interest Rate, Random Effects Regression Model