Effect of Credit Risk on Profitability of Commercial Banks in Sri Lanka

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ABSTRACT

Financial institutions play a massive role in achieving the economic growth of a country. Here, the commercial bank's contributions seem vital because commercial banks lend to the people who wish to invest. In this scenario, banks have a threat of unpaid loans. It may adversely affect the profitability of the bank because of the loss of interest income. Therefore, it is critical to understand the relationship between credit risk and profitability. However, previous literature does not indicate a straightforward relationship between credit risk and profitability because there are three different arguments on the same concept: negative relationship, positive relationship, and neutral relationship. Hence, this study investigates the effect of credit risk on profitability using all the commercial banks in Sri Lanka that operated during the 2010-2020 period in order to fill this knowledge gap. Also, the main objective of this study is to assess the relationship between credit risk and profitability. The dependent variable of this study is profitability, and Return on Equity (ROE), Return on Assets (ROA), and Net Interest Margin (NIM) were used to measure it. Credit risk is considered the independent variable of the study and it was measured using the Non-Performing Loan Ratio (NPLR). Firm size, bank age, and GDP growth were used as control variables. The total assets of the bank, years since incorporation, and GDP growth rate are the measurements of these three control variables respectively. In order to assess the relationship between credit risk and profitability, a regression model was used. Ultimately, according to the regression model, this study suggests that non-performing loans positively affect profitability measured using return on equity and return on assets. However, the non-performing loans do not affect profitability measured using net interest margin.

Keywords: Credit risk, Profitability, Sri Lanka

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