Impact of Credit Risk Management on Banks' Profitability: Evidencefrom Licensed Commercial Banks in Sri Lanka

D.A.N.M. Perera[1,*] and H.H. Dedunu[2]

[1,2]*Department of Accountancy and Finance, Faculty of Management Studies, Rajarata University of Sri Lanka,Mihintale, Sri Lanka.*

[*]Corresponding author: pnimesha198@gmail.com

Abstract

Credit risk management in commercial banks has become a more important concept overthe world. Commercial banks should maintain an effective credit risk management mechanism to ensure the bank's survival and growth. Hence, this study aims to examinethe impact of credit risk management on the bank's profitability. The sample of the studyincludes ten licensed commercial banks in Sri Lanka covering the period from 2014 to 2019. The data was collected from the bank's annual reports and websites. Consequently, non-performing loan ratio, capital adequacy ratio, loan to deposits ratio, and leverage ratiohave been used as the measurements of the independent variable where profitability was used as the dependant variable of this study. The profitability was measured via return on equity. Descriptive analysis, correlation analysis and regression analysis were used for the data analysis. The results revealed that the non-performing loan ratio has a negative impact on return on equity, whereas the leverage ratio has a positive impact on return onequity. Further, the study finds that there are no effects of capital adequacy and loan to deposit ratios on return on equity. Accordingly, the impact of credit risk management on the commercial bank's profitability is not crystal clear in the Sri Lankan context. The findings of the study highlight that commercial banks can effectively achieve their profitability objectives by efficiently managing their leverage ratio and non-performing loan ratios. The policymakers and investors can also use the study's findings for their decision making.

Keywords: Capital adequacy ratio, credit risk management, leverage ratio, loanto deposit ratio, non-performing loan ratio