Impact of Credit Risk on Financial Performance of Commercial Banksin Sri Lanka

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Abstract

Credit risk management is becoming a critical factor for every commercial bank around the world. Commercial banks play a predominant role in credit expansion and granting credit facilities in Sri Lanka. Banks are generally facing various kinds of risks. Among these, credit risk makes a severe threat to financial performance. Therefore, the main objective of the study was to examine the impact of credit risk on the financial performance of commercial banks in Sri Lanka. The return on assets and return on equity were used as financial performance indicators and capital adequacy ratio, non-performing loan, growth, size, liquidity, management efficiency, and leverage used as indicators of credit risk. Data were collected from ten banks from 2015 to 2019. Pooled data and panel data regression analysis used to investigate the impact of credit risk on financial performance. According to the panel data analysis, there was no relationship between capital adequacy ratio, non-performing loan, growth, liquidity, and leverage with financial performance. Only bank size and management efficiency had relationships with financial performance. There was a significant negative relationship between size and financial performance. And management efficiency had a positive significant relationship with financial performance. Based on the analysis, the researcher concludes that the financial performance can be strengthened if the banks manage their credit risk more efficiently. The findings of the study are useful for bankers, depositors, investors, and government policymakers. Because the credit risk was important for all parties. Therefore, the study recommended the banks to implement effective tools and techniques to increase management efficiency.

Keywords: Capital adequacy ratio, management efficiency, non-performingloans, size