

DETERMINANTS OF PROFITABILITY OF LICENSED COMMERCIAL BANKS IN SRI LANKA

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INTRODUCTION

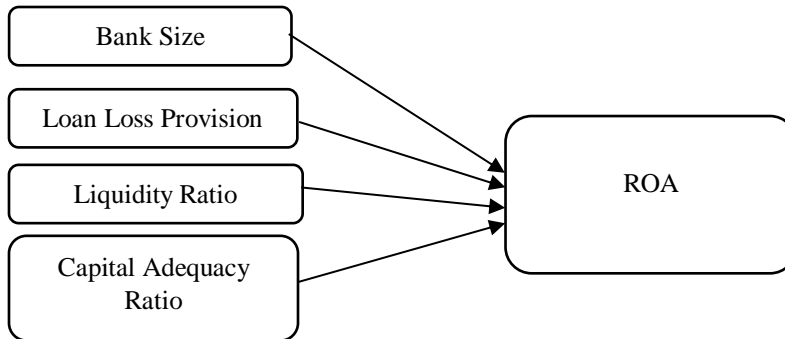
The banking sector significantly impacts economic movements in all countries since banks play a pivotal role in improving overall economic activities, which are crucial for economic development. When considering the profitability of the banking sector, profit is a significant requirement of a competitive banking institution, as it is essential for running the business in a period of growing competition in financial markets. Thereby, both external and internal factors have been affecting the profitability of the banks. As a result, many parties are interested in the determinants that influence bank profitability. The banking industry has undergone some significant changes over the past 20 years as a result of technological advances and the inevitable forces cruising globalization, which present both opportunities for growth and challenges for the banking industry to remain profitable in this more hypercompetitive environment (Weersainghe, 2013). This study's primary concern is investigating the banking sector's profitability determinants. Previous studies have found mixed results on this topic. They are focused on liquidity to measure profitability. Therefore, this paper aims to investigate the bank-specific determinants, such as Bank Size, Loan Loss Provisions, Liquidity, and Capital Adequacy ratio as the determinants of profitability while taking Return on Assets (ROA) as the dimension of profitability of Licensed Commercial Banks (LCB) listed on the Colombo Stock Exchange in Sri Lanka from 2016 to 2022.

METHODOLOGY

The population of the study was the LCBs in Sri Lanka; accordingly, there are 24 LCBs in Sri Lanka. The researcher took over 17 Banks among the selected population. Using this selected sample, the researcher tried to illustrate how popular Sri Lankan commercial banks have performed during the selected period. The primary source of information gathered in this study was based on secondary data collected over the period from 2016-2021. Here, secondary data probably provided the primary source to answer the research question and address the research objective. Accordingly, annual reports and financial statements of the LCBs and Central Bank reports of Sri Lanka have been used as secondary data collection processes.

This study used the quantitative approach; the dependent variable is ROA. Four independent variables are bank size, loan loss provision, liquidity ratio, and capital adequacy ratio. Thus, the conceptual framework of the study is developed as shown figure 1. A study carried out by Staikouras and Wood (2003), in their studies revealed that bank size was found to be negatively related to profitability. Weerasinghe (2013), Madhushani and Wellappuli (2016), Sufian and Chong (2008) and Deger and Adem (2011) have found that bank size has a positive relationship with profitability. Thus, the researchers assumed a significant relationship between bank size and profitability.

Figure 1
Conceptual Framework



Accordingly, the researcher developed this study's hypotheses with the support of past studies.

H₁: There is a significant impact of bank size on the profitability of LCBs

Kosmidou (2007) found a positive relationship between the ratio of loan loss provisions over total loans (asset quality) and profitability. Extant studies provide the first evidence that loan loss provision has a negative impact on the profitability of Jordanian commercial banks. Thus, the researcher assumed a significant relationship between loan loss provision and bank profitability.

H₂: There is a significant impact of loan loss provision on the profitability of LCBs.

Demircuc-Kunt and Huizinga (1999) and Dang (2011) revealed that an adequate liquidity level is positively related to bank profitability. However, Weerasinghe (2013) found a negative significant relationship between liquidity and profitability in Sri Lanka. However, Kawshala (2017) found no significant relationship between the liquidity and profitability of commercial banks in Sri Lanka. Thus, the researcher assumed a significant relationship between liquidity ratio and bank profitability.

H₃: There is a significant impact of the Liquidity ratio on the profitability of LCBs.

According to Weerasinghe (2013), banks with higher capital levels outperform their less capitalized rivals. Numerous academics have employed this ratio (Weerasinghe, 2013); (Thevaruban, 2017). This ratio is positively related to the financial soundness of the bank. Thus, it is negatively related to a possible failure (Kumar & Thamiil, 2014). Thus, the researcher assumed a significant relationship between the capital adequacy ratio and bank profitability.

H₄: There is a significant impact of the Capital Adequacy ratio on the profitability of LCBs.

The study applied a quantitative method for data collection. Hence, the collected data was analyzed. Descriptive statistical analysis, regression analysis, and correlation analyses were conducted in this study.

RESULTS AND DISCUSSION

Descriptive Analysis

Table 1 displays descriptive statistics such as Mean value, Minimum Value, Maximum value, Standard Deviation, Skewness, and Kurtosis among the collected data of banking profitability

determinants, such as Bank Size, Loan Loss Provision, Liquidity Ratio, Capital Adequacy Ratio, and Return on Assets.

Table 1
Summary of Descriptive Analysis

	Mean	Min	Max	SD	Skewness	Kurtosis
BS	11.672	10.36	19.38	0.966	4.881	40.919
LLP	6.614	0	9.98	3.686	-0.975	2.368
LR	2.202	2	3.1	0.181	2.098	10.385
CAR	14.938	0	56.99	9.303	1.145	8.117
ROA	1.241	0.5	2.01	0.460	-0.072	2.049

Correlation Analysis

This table includes the correlation analysis used to study the strength of the relationship between profitability determinants and the profitability of listed commercial banks in Sri Lanka.

Table 2
Correlation Analysis

	ROA	BS	LLP	LR	CAR
ROA	1				
BS	-0.195*	1			
LLP	0.397**	0.073	1		
LR	-0.204*	-0.168	-0.094	1	
CAR	-0.247*	0.030	-0.139	0.126	1

** p<0.01, *p<0.05

The correlation analysis table displays the correlation of Bank Size, Loan Loss Provision, Liquidity Ratio, and Capital Adequacy Ratio with ROA. It displays a weakly negative relationship between the BS and ROA with a -0.195 correlation coefficient at the 0.05 level of confidence (p= 0.050).

The correlation coefficient is 0.397, indicating a weak positive relationship between the LLP and ROA at the 0.01 confidence level (p= 0.000). The correlation coefficient is -0.204, showing a significant and weak negative relationship between the LR and ROA at the 0.05 level of confidence (p= 0.040). CAR and ROA have a weak negative relationship by generating a correlation coefficient -0.247 at the 0.05 confidence level (p=0.012).

Regression Analysis

Table 3 shows the results of the panel regression where the Random Effects Model is considered [i.e., due to the significant (p > 0.05) result of the Hausman test performed].

Regression analysis under the Random Effect model is stated as follows.

Table 3*Summary of Regression Analysis*

ROA	Coef.	Std. Err.	z	P> z
BS	-0.062	0.043	-1.450	0.146
LLP	0.024	0.010	2.220	0.027
LR	-0.575	0.182	-3.160	0.002
CAR	-0.010	0.004	-2.530	0.011
_cons	3.232	0.652	4.960	0.000
Hausman Test (Chi-squared) 5.93 (p<0.05)				
R ² = 0.237				

Under the random effect regression table 3, regression reflects a 23.69% contribution of profitability variables towards ROA in listed commercial banks in Sri Lanka. The constant statistic is 3.232 units, which shows the model would predict if all independent variables were zero. As per the results mentioned in Table 3, with the coefficient of -0.063 in the bank size, it can be stated that there is no relationship between ROA. Past studies revealed that bank size negatively affected profitability (Alice, 2015; Staikouras & Wood, 2003). The impact of bank size on profitability can vary depending on the specific market conditions, regulatory environment, management practices, and other factors. While the regression analysis may highlight a negative relationship, the reasons behind it are often more complex and require further investigation and analysis to understand fully. The β coefficient for the loan loss provision is 0.024. This result explains that on average, if one time of loan loss provision increases, ROA will increase by 0.024%. That means loan loss provision has a weak positive relationship with ROA. The findings of Kosmidou (2007) are consistent with this finding. The relationship between loan loss provisions and ROA may vary depending on factors such as the economic environment, the quality of the loan portfolio, and the overall risk appetite and management practices of the bank. The liquidity ratio has a weak negative impact on banking profitability. The findings of Demircuc-Kunt and Huizinga (1999) and Dang (2011) are consistent with our findings. A weak negative impact on profitability may exist; liquidity is vital to a bank's financial health and overall stability. Prudent liquidity management ensures the bank can meet its obligations even during adverse economic conditions. The right liquidity strategy depends on the specific circumstances of the bank, its risk appetite, and the prevailing economic environment. The study indicated a negative relationship between the capital adequacy ratio and bank profitability. It is noted that while a negative relationship may exist between the capital adequacy ratio and bank profitability, a solid capital base is essential for financial stability and resilience, which are crucial aspects of a well-functioning banking system. Striking the right balance between capital adequacy and profitability is a complex challenge that banks and regulators continuously navigate to ensure the health and stability of the banking industry. Accordingly, H₂, H₃, and H₄ are supported, while H₁ is not.

CONCLUSION AND IMPLICATIONS

The main problem addressed in this study was to investigate determinants of the profitability of LCBs in Sri Lanka. In this study, the population was Licensed Commercial Banks in Sri Lanka, and the sample was 17 banks. The data was collected from the annual reports for the period of 6 years from 2016 to 2022. Bank size, liquidity ratio, loan loss provision, and capital adequacy ratio were independent variables, while Return on Assets was the Dependent variable. The research examines the relationship between bank profitability and four key

variables: bank size, loan loss provision, liquidity ratio, and capital adequacy ratio. The study revealed that bank size, loan loss provision, liquidity ratio, and capital adequacy ratio significantly impact bank profitability. Additionally, loan loss provision positively impacts bank profitability, while bank size, liquidity ratio, and capital adequacy ratio negatively impact bank profitability. These relationships highlight the effects of each variable on the profitability of banks.

For future research, it is suggested to incorporate the foreign bank sector into the analysis to gain a broader understanding of the factors affecting bank profitability. Additionally, including more variables could lead to more comprehensive and accurate results.

Keywords: Bank size, capital adequacy ratio, liquidity ratio, licensed commercial banks, loan loss provision, return on assets

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