

Impact of Credit Risk on Financial Performance of Sri Lankan Commercial Banks

Rasika, DGL* & Sampath, HR

Abstract

Commercial banks play predominant role in credit expansion and granting credit facilities. Since the banking sector is related to conditions and uncertainty, they are exposed to several types of risks. Among these risks, credit risk makes a severe threat to the financial performance. This study carried out an investigation in to the quantitate effect of Credit Risk on the Financial Performance of Commercial Banks in Sri Lanka with special reference to Systemically Important Banks from 2011 to 2015 using quarterly financial reports. Six commercial banks including two state banks and four largest domestic private banks were selected through purposive sampling by considering the time concern and availability of data. The secondary data collected from the bank's annual reports was analysed using multiple regression analysis. In the model Return on Equity (ROE) was used as the financial performance indicator while Non-Performing Loan Ratio (NPLR) and Capital Adequacy Ratio (CAR) as credit risk indicators. The results of the analysis states that both NPLR and CAR have negative and relatively significant effect on ROE, with NPLR having higher significant effect on ROE in comparison to CAR. Hence, the regression as whole is significant NPLR and CAR reliably predict ROE. Having established a relationship between credit risk and financial performance of commercial banks, the researcher suggests that all banks should adopt a credit risk grading system. Risk grading is a key measurement of a bank's asset quality and as such it is essential that grading is a robust process. The study concluded that credit risk still remains a major concern for the commercial banks in Sri Lanka because credit risk is an important predictor of bank financial performance. The findings help the policy makers in setting better performance targets and enable banks managers to allocate capital more efficiently.

Key words: Credit Risk, Financial Performance, Commercial Banks

To whom correspondence should be addressed: devundaragedara@gmail.com

*Department of Accountancy & Finance, Sabaragamuwa University of Sri Lanka.