

Impact of Credit Risk Management on Financial Performance of Licensed Commercial Banks and Licensed Specialized Banks in Sri Lanka

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Credit risk management of banking sector has become more a crucial aspect of financial system, since it has been facing difficulties over the years. It refers a situation where the borrower has failed to repay loan or interests when they are due. Hence this study analyzed the impact of credit risk management on financial performance of licensed commercial banks and specialized banks in Sri Lanka. And the study further attempts to examine nature of aforementioned relationship based on banking soundness index indicators CAMEL (Capital adequacy, Assets quality, Management efficiency, Earnings and Liquidity). Return on Equity, Net Interest Margin and Earnings per Share used as the measurements of financial performance. Bank size considered as a control variable. Data were collected from 12 commercial banks and 3 specialized banks out of 32 banks in Sri Lanka. The key data source is the audited annual financial statements of selected banks over the 7 years (2011-2017). Pearson correlation and random effect panel regression model were employed to analyze the data. The results revealed that Capital adequacy and Asset quality have negative insignificant impact on financial performance while Loan to Deposit has negative and significant impact on financial performance. In contrast, Management efficiency and Earnings have positive significant impact on financial performance of LCBs & LSBs in Sri Lanka. Therefore, this study suggests that CAMEL model can be used as a proxy for credit risk management and conclude that credit risk still remains a major predictor of the performance of banks in Sri Lanka. The study recommended that banks should initiate Basel III framework, hedge the risk, do the loan portfolio diversification and integrate proactive & reactive approaches to mitigate the credit risk as much as possible to earn high performance and to reduce the compliance risk as well.

Keywords: Credit risk management, Financial performance, CAMEL, Licensed commercial & specialized banks in Sri Lanka