

**THE IMPACT OF CAPITAL ADEQUACY ON PROFITABILITY
OF COMMERCIAL BANKS IN SRI LANKA**



By

CHAMILA VIMUKTHI WASANA WANIGASEKARA

REG NO: EU/IS/2014/COM/15

INDEX NO: COM 1785

A Project Report Submitted to the Faculty of Commerce and Management,
Eastern University, Sri Lanka, as a partial fulfillment of the requirement of the
Degree of Bachelor of Commerce Honors in Accounting and Finance
[BComHons (Accounting and Finance)]



**Department of Commerce
Faculty of Commerce and Management
Eastern University, Sri Lanka**

2020

**PROCESSED
MAIN LIBRARY, EUSL**

ABSTRACT

The purpose of this study is to examine The Impact of capital adequacy on the profitability of commercial banks in Sri Lanka. The return on assets ratio (ROA) used as profitability measures and measures the capital adequacy by using capital adequacy ratio and risk-weighted assets ratio. This study used panel data consisting of 20 commercial banks in Sri Lanka out of 33 commercial banks as a sample for the period of 2014-2018. This research is conducting based on secondary data. Data will be obtained from the financial reports and websites of sample banks and information from annual reports of the central bank in Sri Lanka and also gathered from the website of CSE from 2014 to 2018. STATA used to analyze data. The random-effect model was chosen to examine the impact of capital adequacy on Profitability.

The findings of the study are the capital adequacy ratio and risk-weighted assets ratio contributes to negative significance to the profitability of commercial banks in Sri Lanka. The results of the study proved that a slightly significant impact of capital adequacy on profitability. It means the capital adequacy ratio and risk-weighted asset ratio are significantly affecting the profitability of the banking sector. Also, it is identified that profitability will not depend on capital adequacy in commercial banks. This indicates that the nature of the capital adequacy affects to determine its direction and impact on the profitability of commercial banks in Sri Lanka. There are no sufficient studies in Sri Lanka to identify the impact of capital adequacy on banking profitability. This research will help to fulfill this research gap. Stakeholders and bank managers will be able to use the results and findings from the results of this study and they can make more reliable and effective decisions.

Keywords: Capital Adequacy, Capital Adequacy Ratio, Risk-Weighted Assets Ratio, Return on Assets, Profitability

TABLE OF CONTENTS

ACKNOWLEDGEMENT	i
ABSTRACT	ii
LIST OF TABLES	vii
LIST OF FIGURES	viii
ABBREVIATIONS	ix
CHAPTER ONE INTRODUCTION.....	1
1.1 Background of the study	1
1.2 Problem Statement	5
1.3 Research questions.....	6
1.4 Research Objectives	7
1.5 Significance of the Study	7
1.6 Scope of the Study	7
1.7 Summary	8
CHAPTER TWO LITERATURE REVIEW	9
2.1 Introduction	9
2.2 Capital Adequacy.....	9
2.1.1 Regulations.....	10
2.1.1.1 Framework of Basel Accords.....	10
2.1.1.2 Main Features of the Basel III.....	12
2.2.2 Theories of Capital Adequacy	13
2.2.2.1 Buffer Theory.....	13
2.2.2.2 Deposit Insurance Theory	14
2.2.2.3 Expense Theory	15
2.2.2.4 Market power theory	15
2.2.2.5 Portfolio Regulation theory	15
2.2.3 Capital Adequacy Ratio (CAR)	16
2.2.4 Risk-weighted Asset Ratio (RAR)	16
2.3 Profitability.....	17

2.3.1 Ratios.....	17
2.3.1.1 Return on Assets (ROA).....	18
2.4 The Banking Sector in Sri Lanka.....	18
2.5 Relationship between Capital Adequacy and Profitability	20
2.6 Empirical Evidence	20
2.7 Evidence in the Sri Lankan Context	25
2.8 Summary	27
CHAPTER THREE CONCEPTUALIZATION AND OPERATIONALIZATION ..	28
3.1 Introduction	28
3.2 Conceptualization	28
3.2.1 Capital Adequacy	29
3.2.1.1 Capital Adequacy Ratio (CAR)	30
3.2.1.2 Risk-weighted Assets Ratio (RAR).....	31
3.2.2 Profitability	31
3.2.2.1 Return on Assets (ROA).....	32
3.3 Operationalization.....	32
3.4 Summary	33
CHAPTER FOUR METHODOLOGY	34
4.1 Introduction	34
4.2 Study Setting, Study Design, and Method of study.....	34
4.3 Study Population and Sample.....	34
4.4 Data Collection	35
4.5 Methods of Data Presentation and Analysis.....	35
4.5.1 Descriptive Analysis.....	35
4.5.2 Unit Root Test.....	36
4.5.3 Correlation Analysis.....	36
4.5.4 Diagnostic Test	37
4.5.4.1 Heteroskedasticity	37

4.5.4.2 Autocorrelation	38
4.5.4.3 Multicollinearity	38
4.5.4.4 Normality	39
4.5.5 Regression Analysis	39
4.6 Testing Hypothesis.....	40
4.7 Summary	41
CHAPTER FIVE DATA PRESENTATION AND ANALYSIS	42
5.1 Introduction	42
5.2 Data Analysis.....	42
5.2.1 Descriptive Analysis of Independent Variables.....	42
5.2.2 Descriptive Analysis of Profitability	44
5.3 Unit root test.....	46
5.4 Correlation Analysis	46
5.5 Diagnostic Test	47
5.5.1 Heteroskedasticity	47
5.5.2 Autocorrelation	47
5.5.3 Multicollinearity.....	48
5.5.4 Normality	48
5.6 Regression Analysis.....	49
5.6.1 Fixed Effect Model.....	49
5.6.2 Random Effect Model	50
5.6.3 Hausman Test.....	50
5.7 Testing Hypothesis.....	51
5.8 Summary	52
CHAPTER SIX DISCUSSION.....	53
6.1 Introduction	53
6.2 Discussion on Descriptive Analysis.....	53
6.2.1 Descriptive Statistics for Independent Variable Capital Adequacy	53

6.2.2 Descriptive Statistics for Dependent Variable Profitability	53
6.3 Relationship between Capital Adequacy and Profitability	54
6.3.1 Relationship between Capital Adequacy Ratio and Return on Asset	54
6.3.2 Relationship between Risk-weighted Asset Ratio and Return on Asset	54
6.4 Impact of Capital Adequacy on Profitability	55
6.5 Summary	56
CHAPTER SEVEN CONCLUSION AND RECOMMENDATION	57
7.1 Introduction	57
7.2 Conclusions	57
7.3 Recommendations.....	58
7.4 Limitations.....	58
7.5 Suggestions for future researchers.....	59
7.6 summary	59
REFERENCE.....	60
APPENDIX – I.....	66
APPENDIX – II.....	67
APPENDIX- III.....	71