

THE IMPACT OF CREDIT RISK MANAGEMENT VARIABLES ON
PROFITABILITY OF COMMERCIAL BANKS IN SRI LANKA

JEYARAJ STEPHEN SHERIN MANUSHIKA



FCM1741



Project Report
Library - EUSL

1741

ABSTRACT

Banks operate in an environment of considerable risks and uncertainty. Credit risk has always been a vicinity of concern not only to bankers but to all in the business world because the risks of a trading partner not fulfilling the obligations in full or due date can jeopardize the affairs of the other partner. Credit risk management in banks has become more important not only because of the series of financial crisis that the world has experienced in the recent past, but also the introduction of Basel II Accord. In this context, the research was carried out to identify the Impact of Credit Risk Management variables on Profitability in Commercial Banks in Sri Lanka.

The objective of the study was to empirically examine the impact of credit risk variables on profitability of commercial banks in Sri Lanka. For the purpose secondary data collected from 17 sample commercial banks for a six year period (2010-2015) were collected from annual reports, Fitch rating reports and financial statements of respective commercial banks of Sri Lanka. Capital adequacy ratio and Non-performing loan ratio is selected as the measure of credit risk management while, Return on assets and Return on equity is selected as the measures of profitability. The data were analyzed using a Descriptive Statistics, Correlation Analysis, Regression Analysis and Independent Sample t-test. Overall results showed credit risk management variables have significant impact on profitability. The study suggested a need for enhancing credit risk management to maintain the prevailing profitability of commercial banks in Sri Lanka.

Key words: Capital adequacy ratio, Non-performing loans ratio, Return on Assets, Return on Equity, Credit risk management, profitability,

Table of Contents



Acknowledgement.....	i
Abstract.....	ii
Table of Contents.....	iii
List of Tables.....	viii
List of Figures.....	ix
Abbreviations.....	x

CHAPTER ONE - INTRODUCTION

1.1 Background of the Study.....	1
1.2 Problem Statement.....	3
1.3 Research Questions.....	4
1.4 Objectives of the Study.....	5
1.5 Scope of the Study.....	5
1.6 Significance of the Study.....	6
1.7 Summary.....	6

CHAPTER TWO – LITERATURE REVIEW

2.1 Introduction.....	7
2.2 Banks' Risk Management.....	7
2.2.1 Risks in Banks.....	7
2.2.2 Sources of Credit Risk.....	9
2.3 What is Credit.....	11
2.3.1 Credit process.....	11
2.4 Credit Risk management.....	12
2.4.1 Credit Risk Management Practices.....	13
2.4.2 Essentials of Effective Credit Risk management in Banking.....	14
2.4.3 Credit Risk Management Indicators.....	14

2.4.3.1 Capital Adequacy Ratio (CAR).....	15
2.4.3.1.1. Appropriate capital adequacy ratio in Sri Lanka.....	15
2.4.3.2. Non-performing loan ratio (NPLR).....	16
2.5 Financial crisis 2008 (United States).....	17
2.6 Regulations.....	19
2.6.1 The Evolving Basel Accord.....	19
2.6.2 Capital requirement.....	19
2.6.3 The key features of Basel II.....	20
2.6.3.1. Pillar 1: Minimum capital requirement.....	20
2.6.3.2 Pillar 2: The supervisory review process.....	21
2.6.3.3. Pillar 3: Market Discipline.....	21
2.6.4. Overall Benefits of Basel II.....	21
2.7 Bank's Profitability.....	22
2.7.1 Return on Equity (ROE).....	23
2.7.2 Return on Assets (ROA).....	24
2.8 Summary.....	25

CHAPTER THREE – CONCEPTUAL FRAMEWORK AND OPERATIONALIZATION

3.1 Introduction.....	26
3.2 Conceptualization.....	26
3.2.1 Credit Risk Management (CRM).....	27
3.2.1.1 Capital Adequacy Ratio (CAR).....	27
3.2.1.2 Non-performing loan ratio (NPLR).....	29
3.2.2 Profitability.....	29
3.2.2.1 Return on Equity (ROE).....	30
3.2.2.2 Return on Assets (ROA).....	30
3.3 Hypothesis of the study.....	30
3.4 Operationalization.....	31
3.5 Summary.....	31

CAPTER FOUR - METHODOLOGY

4.1 Introduction.....33

4.2 Research Design and Setting.....33

4.3 Study Population and Sampling.....33

4.4 Method of Data Collection.....34

4.5 Data Analyzing.....34

 4.5.1 Univariate Analysis.....34

 4.5.2 Bivariate analysis.....34

 4.5.2.1 Correlation analysis.....35

 4.5.3 Multivariate Analysis.....36

 4.5.3.1 Multiple Regression Analysis.....36

 4.5.3.2 Hypotheses of the Study.....38

 4.5.4 Independent sample t – test.....39

4.6 Summary.....40

CHAPTER FIVE – DATA PRESENTATION AND ANALYSIS

5.1 Introduction.....41

5.2 Data Presentation.....41

5.3 Test of Normality and Multi-co linearity.....42

5.4 Data Analysis.....43

 5.4.1 Univariate Analysis.....43

 5.4.1.1 Descriptive Statistics Analysis.....43

 5.4.2 Bivariate Analysis.....44

 5.4.2.1 Correlation Analysis.....45

 5.4.2.1.1 Correlation between Capital Adequacy Ratio and Return on
Assets.....45

 5.4.2.1.2 Correlation between Capital Adequacy Ratio and Return on
Equity.....45

5.4.2.1.3 Correlation between Non-performing Loan and Return on Assets.....	46
5.4.2.1.4 Correlation between Non-performing Loan and Return on Equity.....	46
5.4.2.1.5 Summary of Correlation.....	47
5.4.3 Multivariate Analysis.....	47
5.4.3.1 Multiple Regression Analysis.....	47
5.4.3.1.1 Regression Analysis for Impact of Credit Risk Management Variables on Return on Asset.....	48
5.4.3.1.2 Regression Analysis for Impact of Credit Risk Management on Return on Equity.....	50
5.4.3.1.3 Summary of Impact.....	52
5.4.4 Independent Sample t – test.....	52
5.4.4.1 Independent Sample t – test for Profitability of Local and Foreign banks.....	52
5.4.4.2 Independent Sample t – test for Credit Risk Management of Local and Foreign banks.....	54
5.4.4.3 Summary of differences of Profitability and Credit-Risk Management in local and foreign commercial banks.....	57
5.5 Summary.....	58
 CHAPTER SIX – DISCUSSION	
6.1 Introduction.....	59
6.2 Discussion on Descriptive Statistics.....	59
6.3 Discussion on the Relationship between Credit Risk Management and Profitability of Commercial Banks in Sri Lanka.....	60
6.3.1 Relationship between Capital Adequacy and Return on Assets.....	60
6.3.2 Relationship between Capital Adequacy and Return on Equity.....	60
6.3.3 Relationship between Non-performing Loan Ratio and Return on	

Assets.....61

6.3.4 Relationship between Non-performing Loan Ratio and Return on Equity.....62

6.3.5 Discussion on the relationship between Credit Risk Management and Profitability of Commercial Banks in Sri Lanka.....63

6.4 Discussion on the Impact of Credit Risk Management on Profitability of Commercial Banks in Sri Lanka.....63

6.4.1 Impact of Credit Risk Management on Return on Assets.....63

6.4.2 Impact of Credit Risk Management on Return on Equity.....63

6.4.3 Overall Impact of Credit Risk Management on Profitability.....64

6.5 Discussion on the Difference of Profitability and Credit Risk Management in local and foreign commercial banks in Sri Lanka.....65

6.6 Summary.....67

CHAPTER SEVEN – CONCLUSION AND RECOMMENDATION

7.1 Introduction.....68

7.2 Conclusion and Recommendation.....68

7.3 Suggestions for further Research.....70

7.4 Summary.....70

Appendix

References