

## The Effect of Non-Performing Loans on Profitability of Commercial Banks in Sri Lanka

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### ABSTRACT

**Introduction** - Sri Lanka commercial Banks have remained with persistent challenge of managing non-performing loans that are considered to have effects on its profitability. Together with the banking sector, the government has developed different ways of reducing non-performing loans. This study seeks to find out the effects of nonperforming loans on profitability of commercial banks in Sri Lanka.

**Design/Methodology/Approach** - The study used commercial banks registered and operational in Sri Lanka as at CBSL in 2018. Profitability calculated by return on assets and used as a dependent variable and non-performing loans ratio is used as independent variable. Capital adequacy, operational efficiency and liquidity are used as control variables to enhance the validity and accuracy of the tests. The research selected 11 commercial banks during the period of 2014 to 2018 and used the secondary data. Descriptive Statistics, Multiple Linear Regression and Pearson Correlation were used for data analysis and Stata has been used as statistical software to analyse the collected data.

**Findings** - The study indicates that there is negative effect of nonperforming loans ratio on return on assets, confirming that non-performing loans negatively affects profitability of commercial banks in Sri Lanka. There is a positive and significant relationship between Return on Assets and Capital Adequacy. When considering the relationship between Return on Assets and Liquidity there is a positive insignificant relationship and there is a negative relationship between Return on Assets and Operational Cost Efficiency.

**Conclusion** - Managers of Commercial banks in Sri Lanka have to work hard to enhance profitability of commercial banks and reduce occurrences of nonperforming loans. This paper therefore provides an insight to commercial banks, central bank and other stake holders on the effect of nonperforming loans on profitability of commercial banks in Sri Lanka and provides a basis for further research.

**Keywords:** *Non-Performing Loans, profitability, CAMEL factors, Commercial banks, Central Bank of Sri Lanka.*