

The Impact of Leverage on the Profitability of Commercial Banks in Sri Lanka

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Abstract

Introduction: This study investigates the impact of leverage on profitability in Sri Lanka's licensed commercial banks from 2020 to 2023 (using quarterly data), focusing on indicators such as Degree of Financial Leverage (DFL), Degree of Operating Leverage (DOL), Debt-to-Equity Ratio (DER), and Asset Growth. It aims to understand how excessive leverage, amidst fluctuating economic conditions, might affect both financial stability and profitability.

Methodology: This quantitative study analyzes the impact of leverage on the profitability of 10 licensed commercial banks in Sri Lanka from 2020 to 2023 using secondary data from quarterly financial statements. Key leverage variables—Degree of Financial Leverage (DFL), Degree of Operating Leverage (DOL), Debt-to-Equity Ratio (DER), and Asset Growth—are assessed for their relationship with Return on Assets (ROA), which measures profitability. The study employs regression analysis to determine the influence of leverage on profitability, with correlation analysis examining the strength and direction of these relationships. Diagnostic testing ensures the reliability of the regression model by addressing potential issues like multicollinearity and heteroscedasticity.

Findings: The overall regression model was found to be statistically insignificant with an R-squared value of 0.0349, indicating a poor fit. Among the independent variables, only DER showed a significant positive relationship with ROA, suggesting that higher debt relative to equity correlates with improved profitability. The other variables, DFL, DOL, and Assets Growth, were not significantly related to ROA. This implies that while DER can be a factor in enhancing profitability.

Conclusion: The study concludes that traditional leverage measures, such as DFL and DOL, have no significant impact on bank profitability, while DER shows a marginally positive effect. Asset growth alone does not significantly enhance profitability. Therefore, banks should focus on optimizing their capital structure, improving operational efficiency, and managing assets strategically. Policymakers should promote sustainable leverage and better risk management. Researchers should explore other profitability determinants, and investors should prioritize banks with balanced leverage and effective asset management for sustainable growth.

Keywords: Corporate governance, financial performance, Return on equity, Return on Assets, Gender of board members.