BANK-SPECIFIC DETERMINANTS OF PROFITABILITY: EVIDENCE FROM SRI LANKAN DOMESTIC COMMERCIAL BANKS

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Abstract

This study aims to examine the bank-specific determinants that influence the profitability of domestic commercial banks in Sri Lanka, offering insights into which internal factors most significantly affect their financial performance. A balanced panel dataset comprising 70 observations from 10 domestic commercial banks over the period 2018–2024 was analysed using fixed effects regression. Return on Assets (ROA) was employed as the measure of profitability. The study evaluated the impact of key bank-specific variables such as bank size, capitalisation, asset structure, financial structure, asset quality, operational efficiency, revenue diversification, and liquidity. The findings revealed that capitalisation, asset quality, operational efficiency, and revenue diversification positively influence bank profitability. In contrast, bank size and liquidity have a negative impact. No statistically significant relationship was found between profitability and the variables of asset structure and financial structure. This study contributes to the limited body of empirical research focusing on the Sri Lankan banking sector by using recent data and a robust econometric approach to identify internal drivers of profitability. The findings offer practical implications for bank management and policymakers in optimising operational strategies to improve profitability.

Keywords: Bank-specific determinants, commercial banks, panel data analysis, profitability, Sri Lanka

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Introduction

Banks play a crucial role in any economy as they significantly contribute to the development of an economy through the facilitation of financial intermediation. Hence, the stability, efficiency and consequently profitability of the banking sector are of vital importance for the stability and growth of the whole economy (Al-Omar and Al-Mutairi, 2008). In 2024, Sri Lanka's commercial banking sector continued to maintain stability by conserving capital and liquidity well above the regulatory minimum levels and also maintaining compliance with prudential requirements (Central Bank, 2024). This sector accounts for 61.9% of total assets by the end of 2024 (Central Bank, 2024), reflecting an increase in investment. Other significant improvements in the performance of the banking sector can be identified as: credit quality of the sector based on Non-Performing Loans (NPL) ratio improved, and profitability improved (Central Bank, 2024). Both Return on Assets (ROA) and Return on Equity(ROE) improvements indicated better operational efficiency. Credit expansion, especially in the SME and retail sectors, led to loan portfolio growth. Asset quality improved with a lower NPL ratio, supported by better borrower repayment capacity and proactive loan restructuring. The sector maintained strong capital adequacy and liquidity positions, despite challenges like sovereign debt restructuring and narrowing net interest margins. Banks focused on enhancing digital infrastructure and governance, with the Central Bank enforcing regulatory reforms to ensure stability (Central Bank, 2024). In the literature, the determinants of profitability of Banks are expressed as bank-specific determinants and macroeconomic determinants (Al-Omar and Al-Mutairi, 2008; Athanasoglou, Delis and Staikouras, 2008; Alper and Anber, 2011; Louzis et al, 2010; Sufian and Kamarudin, 2012). Many empirical studies have been done on determinants of bank profitability, and such determinants are well documented in many other countries. However, comprehensive studies to assess the bank-specific determinants of profitability in the Sri Lankan context are further required. Therefore, this study may fill the empirical gap regarding this aspect. Hence, the objective of this study is to investigate the impact of bank-specific determinants, i.e., bank size, capitalisation, asset structure, financial structure, asset quality, operational efficiency, revenue diversification and liquidity, on the profitability of Sri Lankan domestic Commercial Banks during the period from 2018 to 2024.

Literature Review

Firm-specific determinants mostly reflect the bank's management decisions, policy objectives and practices about sources and utilisation of funds, capital, liquidity, and expense management. Athanasoglou, Delis and Staikouras(2005) rationalised that small-sized institutions try to grow faster even at the expense of profitability. Accordingly, recently incorporated institutions put more emphasis on increasing their market share rather than improving profitability. However, a few other researchers argue that marginal cost savings could be achieved by increasing the size of the bank, especially as the market develops (Sufian and Kamarudin, 2012). Sufian and Chong (2008) also highlight that in the literature, profitability and size found mixed relationships, while in some cases, a U-shaped relationship is identified. Alper and Anbar (2011) and Sufian and Kamarudin (2012) found a positive relationship between profitability and size; however, Athanasoglou, Delis and Staikouras(2005) claim that there is no significant relationship between size and profitability. Hence, the size of banks and their profitability may be expected to be in a non-linear relationship. The relationship of capitalisation with profitability is expected to be positive, and most of the empirical findings support a positive relationship. Athanasoglou, Delis and Staikouras(2005) stressed that sound capital pursues more opportunities, more effectively, offers more time and flexibility to handle unexpected losses, and hence supported increased profitability. However, Hoffmann (2011) suggests that well-capitalised banks tend to reduce the risk of equity and, accordingly, lower the expected return on equity. Further, higher equity reduces the profit after tax by reducing the tax shield provided by the tax deductibility of interest payments on borrowed funds.

Sufian and Kamarudin (2012) argue that loans and advances are assumed to be the main source of profitability and are expected to affect performance positively. However, they also anticipate a negative relationship due to weak asset quality, especially during adverse economic conditions. Alper and Anbar (2011) highlight that the more deposits are transformed into loans, the higher the interest margin and profit. Hence, banks with a higher composition of deposits in their Financial Structure are more profitable. However, Flamini et al. (2009) disagree and justify that banks which are more dependent on deposits for their funding needs are less profitable, possibly due to expenses required to have extensive branch networks and other expenses that may be incurred to administer the deposit accounts. Asset Quality is directly related to the credit function of banks, and it can be identified as Credit Risk. Hoffmann (2011) highlights that financial institutions are more vulnerable to high credit risk than other institutions. Athanasoglou, Delis and Staikouras(2005) also highlight that the bank can improve profitability by improving screening and monitoring of credit risk, and such policies involve the forecasting of future levels of risk. In the banking literature, many researchers argue that the institution with high loan growth often faces more losses as credit appraisals and analysis procedures are less rigorous, but it may allow the institution to charge a high margin, representing a risk-return trade-off. Further research on bank failures, explaining the causes, found that a major proportion of assets were kept under nonperforming loans before failures (Sufian and Parman, 2009).

Several researchers highlight that the relationship between profitability and expenses appears to have a straightforward negative relationship; this may not always be the case (Kosmidou, 2008; Olweny and Shipho, 2011). This is because a higher degree of expenses may be associated with higher volumes of activities and enhance the revenues. Flamini et al. (2009) pointed out that high operating expenses erode profits except for banks that manage to pass on their costs to depositors and lenders. Revenue diversification specifies moving away from traditional revenue sources and toward fee and commission income, dividend income, trading revenue and other operating income, including income from off-balance sheet activities. Alper and Anbar (2011) found a positive relationship between profitability and revenue diversification in the Turkish banking sector. This indicates that greater bank activity diversification positively influences returns. The relationship between profitability and liquidity are often discussed in banking literature. Sufian and Parman (2009) state, "liquidity risk arising from the possible inability of a bank to accommodate a decrease in liabilities or to fund increases on the assets' side of the balance sheet, is considered an important determinant of bank profitability". Accordingly, holding of high liquidity is at the opportunity cost of lending with high returns. Further, banks are engaged in the maturity transformation process, where short-term deposits will be converted to long-term advances. This process would constantly involve the risk associated with maturity mismatches (Guru et al., 2002).

Based on the literature, the hypotheses below were developed:

H1: *There is a positive relationship between bank size and bank profitability.*

H2: *There is a positive relationship between capitalisation and bank profitability.*

H3: *There is a positive relationship between net Loans and Advances to total Assets Ratio and bank profitability.*

H4: *There is a positive relationship between the Deposits to Total Assets Ratio and bank profitability.*

H5: *There is a negative relationship between Credit Cost Ratio and bank profitability.*

H6: *There is a negative relationship between the Cost to Income Ratio and bank profitability.*

H7: *There is a positive relationship between Non-Interest Income as a percentage of Total Assets and bank profitability.*

H8: *There is a negative relationship between liquidity and bank profitability.*

In terms of Sections 21(1) and 76H of the Banking Act, No. 30 of 1988, as amended, the Central Bank of Sri Lanka has determined that every licensed commercial bank and licensed specialized bank shall maintain Liquidity Coverage Ratio (LCR) and Net Stable 'Funding Ratio (NSFR) as the statutory liquidity ratios, in accordance with "Basel I1I: International Framework for Liquidity Risk Measurement, Standards and Monitoring", "Basel IlI: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools" and "Basel III: The Net Stable Funding Ratio", (Central Bank, 2024). In Sri Lankan literature (Amararathne and Wanigasuriya, 2022; Ruwanthika, Wijekoon and Gunathilaka, 2022), studies examine bank-specific factors and macro-economic factors on profitability till the year 2020, and this study focuses on bank-specific factors and a more comprehensive expansion considering the period of 2018- 2024 for the Sri Lankan Commercial Banks.

Methodology

Study period and sample

In Sri Lanka, 24 Licensed Commercial Banks (LCBs) were identified by the end of 2024 (Central Bank, 2025). This study uses panel data, which combines cross-sectional and time series data for 10 banks covering the period 2018 to 2024. Companies were selected based on the highest market capitalisation value, and the data was collected using company annual reports and secondary data sources.

Variables identified

Based on a comprehensive review of prior studies, this research identifies eight endogenous variables as core explanatory factors hypothesised to affect bank profitability Return on Assets (ROA) is the key ratio and most of the literature on Banks' profitability uses as a measure of profitability (e.g. Sufian and Parman, 2009; Sufian and Chong, 2008; Flamini et al., 2009; Kosmidou, 2008; Alper and Anbar, 2011; Amararathne and Wanigasuriya, 2022; Ruwanthika, Wijekoon and Gunathilaka, 2022). Hence, this study uses the ROA as a proxy for profitability, as suggested in most of the banking literature and is calculated using average assets, as suggested by Flamini et al. (2009). Further, as suggested by Athanasoglou, Delis and Staikouras (2005), before tax profit is considered as the numerator. Bank-specific variables are the internal factors of the banks, and they can be controlled by the management. Based on previous research as analysed in the literature review, we can summarise that the firm-

specific factors, such as bank size, capitalisation, asset structure, financial structure, asset quality, operating efficiency, revenue diversification, and liquidity, are the firm-specific variables that influence profitability. Table 1 presents a comprehensive explanation of the measures used in the study.

Table 1
Definitions, notation and expected effect of the explanatory variables of domestic Commercial Bank profitability

Variable		Measure		Notation	Hypothesised Relationship
Response Variable	Profitability	Net Profit after Tax / Average Assets	X 100	ROA	
Explanatory Variable	Bank Size	Ln (Total Assets)		SIZE	Positive / Negative
	Capitalization	Core Capital (Tier 1) / Total Risk-Weighted Assets	X 100	CCAR	Positive
	Asset Structure	Net Loans & Advances / Total Assets	X 100	LATA	Positive
	Financial Structure	Due to Customers (Deposits) / Total Assets	X 100	DPTA	Positive / Negative
	Asset Quality	Impairment Charges / Average Gross Loans & Advances	X 100	CRCO	Positive
	Operating Efficiency	Operational Cost net of Taxes / Net Interest Income + Other Income	X 100	COIN	Positive
	Revenue Diversification	Non-Interest Income / Total Assets	X 100	REVD	Positive / Negative
	Liquidity	Liquid Assets / Public Deposits	X 100	SLAR	Negative

(Source: Authors' Compilation)

Panel data allows controlling for variables which we cannot observe or measure, or variables that change over time and not across entities. Baltagi (2005) states, "panel data give more informative data, more variability, less collinearity among the variables, more degrees of freedom and more efficiency". This study uses panel data regression to examine the factors which influence the profitability of Sri Lankan domestic Commercial Banks since panel data can take heterogeneity explicitly into account by allowing for subject-specific variables. To estimate the effects of explanatory variables on the profitability of banks, three estimation models were used, namely, pooled Ordinary Least Squares (OLS), the random effects, and the fixed effects. The description of three estimation models – pooled OLS, fixed effects, and random effects is given below:

$$\mathbf{Y}_{it} = \boldsymbol{\alpha} + \boldsymbol{\beta}\mathbf{X}_{it} + \boldsymbol{\varepsilon}_{it} \quad \textbf{(1)} \qquad \mathbf{Y}_{it} = \boldsymbol{\alpha}_i + \boldsymbol{\beta}_i \mathbf{X}_{it} + \mathbf{u}_{it} \quad \textbf{(2)} \qquad \mathbf{Y}_{it} = \boldsymbol{\alpha} + \boldsymbol{\beta}\mathbf{X}_{it} + \mathbf{u}_{it} + \boldsymbol{\varepsilon}_{it} \quad \textbf{(3)}$$

Where,

Y_{it} – is the response variable where *i* = bank and *t* = time (can be measured by ROA)
α – unknown intercept
α_i – unknown intercept constant for each bank (n bank-specific intercepts, i = 1…n)
X_{it} – Explanatory variable
β – is the coefficient for the explanatory variable
ε_{it} – is the cross–sectional error component
u_{it} – is the error term of bank i at time t

As discussed in the previous section, to estimate the panel regression model, three alternative methods, such as the pooled ordinary least squares method (equation 1), fixed effects (equation 2), and random effects (equation 3), were used. Specification tests, such as the Breusch-Pagan Lagrange Multiplier test and the Hausman test, were performed to find the fitted model. Further, the researcher has checked for heteroskedasticity, autocorrelation / serial correlation and multicollinearity in order to ensure reliable estimates. Finally, the researcher has checked for the presence of unobservable time effects by controlling for variables that are constant across entities but vary over time.

Findings and Discussion

Multicollinearity and fixed effects

Multicollinearity is a state of very high intercorrelations or inter-associations among the explanatory variables, which may lead to unreliable and unstable estimates of regression coefficients. Variance Inflation Factor (VIF) measures the relationship of all explanatory variables concurrently and explains how much the variance of a coefficient is inflated due to linear dependence on other explanatory variables. The researchers checked for VIF of the variables (refer to Table 2), and all variables are within the rule of thumb of 10.

Table 2
Variance inflation factor and hausman test

Variable	VIF	1/VIF	---- Coefficients ----		(b-B) Difference	Sqrt (diag(V_b-V_B)) S.E.
			(b) Fixed Effects	(B) Random Effects		
SIZE	5.62	0.177984	-.3654199	-.0850058	-.2804141	.0740848
CCAR	9.23	0.108332	.0215926	.0152701	.0063224	.0082601
LATA	2.79	0.357978	.0099117	-.0015863	.011498	.0050547
DPTA	2.73	0.366310	-.0113599	.0051234	-.0164833	.005186
CRCO	1.21	0.828209	-.5297602	-.5535429	.0237827	.0097656
COIN	5.64	0.177412	-.0433062	-.0415168	-.0017894	.0019566
REVD	1.77	0.566145	.6720816	.6830108	-.0109292	.0267591
SLAR	5.13	0.195081	-.0057707	-.0026573	-.0031134	.0017683

(Source: Authors' Compilation)

The researchers also checked for time fixed effects when running a Fixed effects model by controlling for variables that are constant across entities but vary over time. This eliminates the omitted variable bias caused by excluding unobserved variables that evolve but are constant across banks. A time varying intercept (λt) is included for this purpose and however, the model failed to reject the null (Prob > F = 0.5674) that all years' coefficients are jointly equal to zero. Therefore, it is concluded that no time fixed effects are needed (Table 2).

Descriptive and correlation

Table 3 presents the descriptive statistics for the variables used in the analysis and the Pearson correlation coefficients between variables. While considering the bank-specific factors, the bank size is identified as a profitability determinant factor, but surprisingly with a negative coefficient of 0.3654. This is statistically significant at a 95% confidence level. This indicates that banks with a relatively large asset base are less profitable than the small banks. The finding supports diseconomies of scale in the Sri Lankan Commercial Banking Sector.

Capitalisation is positively correlated with profitability (coefficient 0.0216) and is statistically significant at a 90% confidence level. This confirms that commercial banks with a strong capital base tend to achieve increased profitability, and is consistent with most studies conducted in other countries. However, we may find that the coefficient is not particularly high, likely because capital is highly regulated in Sri Lanka. The Asset Structure (loans and advances to total assets) exhibits a positive and relatively small coefficient of 0.0099, which is statistically insignificant. Loans and advances are identified as the major assets of banks, representing their financial intermediation function; however, they fail to explain them as a profitability determinant factor in Sri Lankan Commercial Banks. This may be due to a reduced spread on intermediation activities, issues related to high credit costs for delinquent loans, and the bank's recent focus on fee-based activities.

Table 3
Descriptive statistics and correlation

	Mean	ROAA	SIZE	CCAR	LATA	DPTA	CRCO	COIN	REVD	SLAR
ROAA	1.73552	1.0000								
SIZE	24.0689	0.5203* 0.0000	1.0000							
CCAR	19.4268	-0.7394* 0.0000	-0.6827* 0.0000	1.0000						

LATA	14.6125	0.5347* 0.0000	0.1554 0.1800	-0.6374* 0.0000	1.0000					
DPTA	65.2948	0.6189* 0.0000	0.5048* 0.0000	-0.7549* 0.0000	0.6307* 0.0000	1.0000				
CRCO	70.7078	-0.2532* 0.0273	-0.1030 0.3761	0.2068 0.0730	-0.1914 0.0977	-0.0584 0.6160	1.0000			
COIN	.617105	-0.8765* 0.0000	-0.7122* 0.0000	0.8211* 0.0000	-0.5326* 0.0000	-0.6702* 0.0000	0.0347 0.7661	1.0000		
REVD	56.4342	0.5419* 0.0000	-0.1668 0.1497	-0.2475* 0.0311	0.2852* 0.0125	0.1776 0.1248	0.0684 0.5573	-0.2883* 0.0116	1.0000	
SLAR	1.5319	-0.7114* 0.0000	-0.4451* 0.0001	0.8546* 0.0000	-0.6628* 0.0000	-0.6879* 0.0000	0.2286* 0.0470	0.7448* 0.0000	-0.2838* 0.0130	1.0000

(Source: Authors' Compilation)

Financial Structure (deposits to total assets) of banks leaves a negative coefficient of 0.0114 and is not statistically significant at any level. This indicates that the financing structure of banks is not a major profitability determinant factor, and it could be concluded that financial structure is insignificant as far as Sri Lankan Commercial Banks are concerned. Asset quality has also been identified as a major factor at a 99% significance level. The coefficient of the credit cost ratio with profitability is -0.5298, which shows that asset quality is positively correlated with a high coefficient. i.e., the higher the asset quality, the higher the profitability. The findings emphasise that asset quality is the chief determinant of the banks' profitability. The result is consistent with almost all the findings in the banking literature. With the above findings, we may conclude that the Commercial Banks that operate with better credit origination standards, efficiency and a timely recovery approach may enhance the profitability. In the case of operating efficiency, a positive relationship (negative relationship with cost to income ratio) is shown with a weak coefficient of 0.0433 and is statistically significant at a 99% confidence level. The finding is in line with most of the other empirical findings in other countries. Accordingly, improving operating efficiency is crucial for enhancing the profitability of Sri Lankan Commercial Banks.

Revenue Diversification appears to be an important determinant of the profitability of Commercial banks in Sri Lanka. Non-interest income as a percentage of total assets shows a positive relationship with a large coefficient of 0.6721 at the significant level of 99%. Hence, this finding suggests a diversification of revenue sources to enhance the profitability of banks. Finally, the statutory liquid assets ratio, a proxy for Liquidity, indicates a relatively small negative coefficient of 0.0058 and is statistically significant at the 99% level. This is mainly because liquid assets are usually associated with lower rates of return; however, in order to avoid insolvency, banks often hold liquid assets, which can be easily converted to cash.

Multiple regression analysis models under Pooled OLS, random effects and fixed effects

Table 4 shows the outcome of the multiple regression analysis under pooled ordinary least squares, random effects and fixed effects.

Table 4
Multiple regression analysis models under pooled OLS, random effects and fixed effects

	Pooled OLS		Random effects		Fixed effects		
	Coef (Std. Err.)	P > |t|	Coef Std. Err.	P > |t|	Coef Std. Err.		P > |t|
Intercept	1.7218 (1.9656)	0.384	4.6100 (2.2231)	0.038	10.5827 (3.1170)		0.006
SIZE	0.0417 (0.0697)	0.551	-0.0850 (0.0826)	0.304	-0.3654 (0.1251)	**	0.014
CCAR	0.0205 (0.0098)	0.042	0.0152 (0.0107)	0.156	0.0215 (0.0105)	*	0.066
LATA	- 0.0047 (0.0088)	0.601	-0.0015 (0.0096)	0.869	0.0099 (0.0077)		0.228
DPTA	0.0125 (0.0052)	0.021	0.0051 (0.0060)	0.399	-0.0113 (0.0095)		0.258
CRCO	- 0.5831 (0.0740)	0.000	-0.5535 (0.0585)	0.000	-0.5297 (0.0803)	***	0.000
COIN	- 0.0413 (0.0039)	0.000	-0.0415 (0.0036)	0.000	-0.0433 (0.0062)	***	0.000
REVD	0.6869 (0.0806)	0.000	0.6830 (0.0733)	0.000	0.6720 (0.0961)	***	0.000
SLAR	-0.0014 (0.0031)	0.670	-0.0026 (0.0030)	0.387	-0.0057 (0.0012)	***	0.001
F Test	F(8, 67) = 112.51				F(8,11) = 15111.66		

Wald Chi2 (8)		Wald Chi2 (8) = 838.35	
Prob > F	Prob > F = 0.0000	Prob > chi2 = 0.0000	Prob > F = 0.0000
R^2 – within	N/A	0.9260	0.9429
R^2 – between	N/A	0.9374	0.5551
R^2 – overall	0.9307	0.9137	0.6688

(Source: Authors' Compilation)

Note: Standard errors are given in parentheses. See Table 1 for definitions of all variables
* Significance at the 90% confidence level
** Significance at the 95% confidence level
*** Significance at the 99% confidence level

Empirical findings of this study illustrate that bank size hurts its profitability with high explanatory power. It elaborates that larger banks are less profitable than smaller banks, which contradicts the economics of scale concept. Further, the finding is compatible with the findings of the previous studies on the profitability of banks, such as in the Philippines (Sufian and Chong, 2008) and the US (Hoffmann, 2011), where banks can take advantage of the economies of scale when the size is small, but these economies of scale become exhausted when a bank's size increases. This indicates that the banks have to cut down their costs when expanding. This may be achieved by enhancing technology, which can positively support an increased profitability. However, this finding is in contradiction with most of the findings, such as in Bangladesh (Sufian and Kamarudin, 2012), Turkey (Alper & Anber, 2011), Southeastern European Region (Athanasoglou, Delis and Staikouras, 2008), Greece (Kosmidou, 2008) and Sub-Saharan Africa (Flamini et al., 2009). The empirical findings emphasise the importance of capital to improve the profitability of domestic Commercial Banks, and accordingly, the banks with strong capital can have better profitability than the banks with limited capital. The finding is consistent with the previous studies in different countries such as Greece (Athanasoglou, Delis and Staikouras, 2005; Kosmidou, 2008), Bangladesh (Sufian and Kamarudin, 2012), South Eastern European Region (Athanasoglou, Delis and Staikouras, 2008), Kenya (Olweny and Shipho, 2011), Philippines (Sufian and Chong, 2008) and Sub-Saharan Africa (Flamini et al., 2009) and inconsistent with the US (Hoffmann, 2011). Athanasoglou, Delis and and Staikouras (2005) suggested that high capital will give more flexibility to handle unexpected losses. The results of Hoffmann (2011) exhibit that higher capital leads to predict less profitability which may be due to risk averse behaviour. The Sri Lankan banking industry is fairly capitalised compared to other countries in the region, and the implementation of Basel III in 2017, which is now in full implementation, requires banks to have enhanced quantity and quality of Capital. Further retention of profits will confirm a certain percentage of internal rates of capital generation and authorities need to consider curtailing dividend distribution unless strong capital is evident.

Asset quality is a key determinant of the profitability of banks, with higher explanatory power. The banks with high delinquent loans tend to have low profitability due to the non-realisation of the time value of the investments, and to create reserves for writing off of impaired assets. Further, the result of the positive relationship (negative with credit cost ratio) is consistent with the findings of previous studies in different countries, including Greece (Athanasoglou, Del, is and and Staikouras2005 & Kosmidou, 2008), Turkey (Alper and Anber, 2011), South Eastern European Region (Athanasoglou, Delis and and Staikouras 2008), Kenya (Olweny and Shipho, 2011) and the Philippines (Sufian & Chong, 2008). The findings on the Greek banking sector (Louzis et al., 2010) highlight that asset quality is closely related to macroeconomic variables such as GDP growth, unemployment rate and lending rate. Importantly, the findings of Louzis et al. (2010) stress that management quality has a greater influence on asset quality. The empirical results of this study also illustrate that banks should focus more on asset quality, which can be achieved through better credit origination standards and proper monitoring and follow-up systems as part of their credit risk management. Further, focus on the loan-to-value ratio, evaluation of creditworthiness, and marketability of the collateral are vital during the credit origination. On the other hand, strict credit evaluation processes may curtail the credit growth of banks. Additionally, early recovery action and close follow-up with high-volume advances will help to reduce asset quality deterioration. Hence, the authorities should concentrate more on credit risk management and timely and efficient follow-up mechanisms as an early warning methodology to avoid asset quality deterioration.

The empirical findings prove that the Operating Efficiency has a positive impact on its profitability. The findings is consistent with the findings of previous studies in different countries, including Greece (Athanasoglou, Delis and and Staikouras., 2005 & Kosmidou, 2008), South Eastern European Region (Athanasoglou, Delis and and Staikouras2008), Kenya (Olweny and Shipho, 2011), Malaysia (Guru et al, 2002) and the Philippines (Sufian and Chong, 2008). A number of researchers highlight that the relationship between profitability and expenses appears to have a straightforward negative relationship; this may not always be the case (Kosmidou, 2008; Olweny and

Shipho, 2011). The finding of this study contradicts the findings of Bangladesh (Sufian & Kamarudin, 2012). Flamini et al. (2009) pointed out that high operating expenses erode profits except for banks that manage to pass on their costs to depositors and lenders.

Revenue Diversification acts as a determinant of profitability for banks with a positive impact. The finding is consistent with Bangladesh (Sufian and Kamarudin, 2012), Turkey (Alper and Anber, 2011), Kenya (Olweny & Shipho, 2011), the Philippines (Sufian and Chong, 2008) and Sub-Saharan Africa (Flamini et al., 2009). The findings suggest that the bank's recent focus on fee and commission income, trading revenue and other operating income, including income from off-balance sheet activities, is profitable compared to relying entirely on traditional financial intermediation. Sufian and Chong (2008) highlight that liquidity risk, arising from the possible inability of banks to accommodate decreases in liabilities or to fund increases on the assets' side of the balance sheet, is considered an important determinant of bank profitability. This study establishes a negative relationship between liquidity and profitability. This is mainly due to the fact that liquid assets are usually associated with lower rates of return; however, in order to avoid insolvency, banks often hold liquid assets, which can be easily converted to cash. Further, the result of the negative relationship is consistent with the findings of previous studies such as Greece (Kosmidou, 2008) and Kenya (Olweny and Shipho, 2011). The liquidity in the banking industry is highly regulated, and Commercial Banks are required to maintain a minimum statutory liquid assets ratio of 20% in addition to ensuring the compliance of liquidity coverage ratio and net stable funding ratio. It could be concluded that liquidity is negatively correlated to the bank profitability and however the explanatory power is relatively small compared to other variables. Further, since the banking sector is running with negative maturity mismatches, maintenance of high-quality unencumbered liquid assets is essential for stability.

Conclusion

This study presented evidence on the bank-specific determinants of profitability of Sri Lankan domestic Commercial Banks. The analysis was conducted for the period 2018- 2024, and employed eight endogenous factors such as bank size, capitalisation, asset structure, financial structure, asset quality, operational efficiency, revenue diversification and liquidity. Findings reveal that bank size is an important variable in explaining the profitability, with a negative impact on profitability, with high explanatory power. Hence, the large banks should focus on economies of scale, say for example, moving to digitalisation may reduce their operating expenses. The capital is also an important factor in explaining profitability, and a well-capitalised Commercial Bank is more profitable; however, explanatory power is weak. Asset quality is also an important factor for profitability, with high explanatory power. In order to control the credit cost, banks need to maintain the delinquent advances at lower levels. This implies that banks should be prudent when providing credit facilities. Further, this emphasises that banks should have sound credit risk management processes and good credit origination processes rather than collateral-based lending. Timely recovery actions are also vital for asset quality. With regard to operational efficiency, a positive relationship is identified with weak explanatory power. This indicates that improving operating efficiency is vital for enhancing the profitability of Sri Lankan Commercial Banks. The empirical finding also suggests that revenue diversification enhances profitability with high explanatory power. This indicates banks should also focus on fee-based activities such as fee and commission income, trading revenue and other operating income, including income from off-balance sheet activities, rather than relying only on traditional financial intermediation. Finally, liquidity is also a determinant of profitability, with very weak explanatory power, indicating that maintaining excess liquidity impacts profitability mainly because liquid assets are associated with lower rates of return; however, maintaining sufficient liquidity is essential in order to avoid insolvency. The empirical findings of this study offer considerable policy relevance. The concept of profitability is vital for banks as better performance helps to improve the stability of the financial system. The sustainability of the Sri Lankan Commercial banking sector depends on its efficiency, profitability, and competitiveness. Further, in view of the recent increase in competition among banks, the bank management, regulators and the policy makers need to identify the factors influencing profitability in order to manage their objectives. The limitation of this study is that the focus is restricted only to endogenous factors; however, exogenous factors also may influence profitability, and the researcher leaves this for future research.

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