

The Impact of Regulatory Capital on Credit growth, Non-Performing Loans, And Bank Efficiency: Evidence from Sri Lanka

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Abstract

Introduction: This paper is regarding the effect of capital regulatory requirements on credit growth, non-performing loans, and bank efficiency in Sri Lanka, focusing on 2008–2022 years. The banking industry in Sri Lanka has faced grabbing new opportunities, as well as challenges, especially in balancing the requirement for capital adequacy with operational performance, since the Basel III laws took effect.

Methodology: The study done a quantitative methodology, evaluating a balanced panel dataset from ten commercial banks with fifteen years, using econometric models such Ordinary Least Squares (OLS), Fixed Effects, and Random Effects. The Capital Adequacy Ratio (CAR), Net Interest Margin (NIM), credit growth, and non-performing loan (NPL) ratios are significant variables that have control for macroeconomic factors which include GDP growth and the policy rates.

Findings: The findings imply that growing capital reserves reduce lending ability since higher CAR levels have an inverse impact on credit expansion. Conversely, there is a positive relationship between CAR and NIM, revealing that higher capital buffers lead to improved operational stability and performance. Nevertheless, there is an astonishingly helpful relationship between CAR and NPLs, which would imply that high credit risk and not poor loan quality should require high reserves. These findings demonstrate how regulatory capital plays a twin role of improving bank stability and risk management at the cost of availability and prosperity of lending. It follows, therefore, that the policymakers should consider a balanced rules approach where capital requirements are adjusted for market conditions and bank-specific risks. Negative impacts on nonperforming loans and credit growth can be softened by increasing operational efficiency and practices related to risk management.

Conclusion: This research contributes to our knowledge of the intricate relationships between regulatory capital and banking performance in developing countries by providing guidance to improve financial regulations to ensure stable and sustainable growth in the banking sector in Sri Lanka. I focus further on the logic behind these collaborations at the end. Why it is each positive and negative.

Keywords: Banks, Regulatory change, Capital, non – Performing Loans, Credit Growth, Net Interest Margin.

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