Impact of Market Risk on the Financial Performance of Licensed Commercial Banks in Sri Lanka

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Abstract

Despite the expansion of the Sri Lankan banking sector, market risk remains a significant challenge. This study investigates the impact of market risk on the financial performance of licensed commercial banks in Sri Lanka. The study examines independent variables such as the degree of financial leverage, book-to-market ratio, gearing ratio, firm size, and debt-to-asset ratio as measures of market risk, with return on assets (ROA) and return on equity (ROE) serving as the dependent variables to assess financial performance. A sample of fourteen licensed commercial banks, selected through convenience sampling, was analyzed using panel data extracted from published annual reports of banks listed on the Colombo Stock Exchange over ten years from 2012 to 2021. Descriptive statistics, correlation analysis, and panel data regression analysis were employed to analyze the data. The Hausman specification test indicated that the fixed effects model was the most suitable for this study. The findings reveal that both financial leverage and firm size have a significant negative impact on ROA and ROE. Additionally, the gearing ratio negatively affects ROA, while the book-to-market ratio significantly negatively impacts ROE. In contrast, the book-to-market and debt-to-asset ratios do not significantly influence ROA, and the gearing and debt-to-asset ratios do not significantly affect ROE. Consequently, the study concludes that market risk has a significant negative impact on the financial performance of licensed commercial banks in Sri Lanka. The findings of this study have several vital implications for Sri Lankan banks and policymakers. Banks should enhance their risk management strategies to address the negative impacts of financial leverage and firm size on their financial performance and carefully evaluate the effects of gearing and book-to-market ratios on returns when making strategic decisions. Policymakers might consider implementing regulations that mitigate these risk factors, such as guidelines on capital structure and risk exposure. For investors, understanding the relationships between market risk variables and financial returns is crucial for making informed investment decisions.

Keywords: Book-to-market ratio, Financial leverage, Market risk, Return on asset, Return on equity.

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