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The Influence of Non-performing Assets on the Profit of Commercial Banks in Sri Lanka

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Abstract:
Licensed commercial banks may be known as organizations that participate in the financial intermediation process, which entails some risk in carrying out their business. This study looked at how non-performing loans and advances, together known as net non-performing assets, impact commercial banks' net profits. The study concentrated on examining the occurrences in relation to Sri Lanka. The Central Bank of Sri Lanka's economic data library continues to be the principal source of secondary data used in this study. The licensed banks in the Sri Lankan banking system continue to be the target audience for the study, from which 24 licensed commercial banks were conveniently chosen. Time-series data from 2001 to 2020 related to the variables have been collected to ensure the accuracy of the research. The data has been analyzed statistically with the aid of E-Views version 10. The results of the regression analysis have revealed that there is a significant impact on the net profit of the commercial banks in Sri Lanka from the non-performing assets of the bank, further revealing that the relationship existing between the variables under consideration is negative, which leads to conclude that the non-performing assets adversely affect the net profit of the commercial banks in Sri Lanka. The researcher suggests future studies focus on a diversified sample to gain a comprehensive overview of the banking sector of Sri Lanka. The results of this research are useful for Sri Lankan commercial banks in managing their credit risk.

Keywords: *Non-performing assets, commercial banks, net profit*

1. Introduction

Financial institutions that issue their holders' securities, such as Licensed Commercial Banks, are referred to as financial intermediates since they encourage fund savers to invest. Financial intermediation, also known as asset transformation, is needed to make sure that money is transferred from surplus to deficit economic units within the system. These institutions, like every other business organization, face risks that must be managed before they can successfully accomplish their profit-oriented goals and objectives. Commercial banks are financial entities that manage financial assets and obligations as part of their operations. The stock of the banking sector is money, as opposed to other commercial organizations like manufacturing companies that have real things in inventory. While conducting business, banks must contend with various internal and external business environment issues, such as Credit Risk, Financial Risk, Operational Risk, Market Risk, etc.

According to Onyeagocha (2001), the term "credit" is specifically used to refer to the confidence that a creditor (lender) bestows upon a debtor (borrower) by granting a loan, which is often made up of cash, products, or securities. When a loan is requested, the lender essentially offers credit to the borrower and accepts his credit on the spot. A deal involving two parties is considered to involve credit if the lender or creditor offers money, goods, or services in return for a promise from the borrower or debtor to make payments later on. The repayment schedule outlines how loans are normally repaid in accordance with the previously agreed-upon conditions of the agreement and includes the amount of principal and interest required throughout the loan. If a loan is repayable at the lender's request, it is referred to as a demand loan. Any loan that requires repayment in equal monthly instalments (EMI) is an instalment loan. A time loan is one that must be paid back in full on the agreed-upon date of maturity (expiration). According to the financed assets, such as a consumer loan for consumer items, banks further categorize their loans. Other categories include personal, mortgage, business, manufacturing, and construction. Additionally, depending on whether or not the collateral supporting the loan or advance was sufficient, they could be categorized as secured or unsecured. Consumers who are given credit facilities end up with non-performing loans and advances (Inekwe, 2010).

This consistently exposes banks to credit risk because there is a probability that the borrower would default. In their portfolios, banks often try to remove or reduce credit risk. Character, capacity, condition, and collateral, sometimes known as the five Cs of credit, are one way to assess a borrower's creditworthiness. Onyia and Oleka (2010) claim that

they are commonly referred to as the "Canons of good lending." In a similar vein, Mather recognized Safety, Suitability, and Profitability as the three essential components of valuing credit, as described in Aremu, Suberu, and Oke (2010). First, they made the case that any advance or loan needed to be secured. This principle gave equal weight to suitable securities, cash flow quantity, and quality.

2. Theoretical Background

Since depositors own the funds that the banks advance as loans and because there is a possibility that the depositors' money could be lost in the event of widespread defaults, non-performing assets (NPA), which includes non-performing loans/advances, are seen as such. It makes sense to define lending and banking as high-risk sectors since on-demand may not be feasible. The subject of risk and uncertainty plays a big part in whether a business succeeds or fails. Pandy (2006) asserts that risk arises when it is impossible to forecast with confidence the occurrence of prospective future events, which makes it impossible to make precise predictions about the cash flow sequence.

Obalemo (2004) defined credit risk as the possibility that a borrower will not make the agreed-upon repayments to the lender. Among the many credit risks are management risk, regional risk, business risk, financial risk, and industrial risk. Due to the possibility of partial or total default, a thorough risk analysis should be performed before issuing loans. The human condition, according to Field (2011), is one of ongoing danger. Therefore, whether they succeed or fail depends on the management of skills and banks' capacity to package loans and advances and deliver such value as would lower default risks.

Robert Bench (1991) asserts that the range of lending (credit) rules ought to cover things like who receives credit, who lends it (and how), how much credit is issued, who determines the price, and the distribution system's organizational structure. This summary of credit policymaking also considers additional issues, such as the type of credit issued and the terms under which it is granted. In the aforementioned definition, Bench makes an attempt to define the reach of credit policy. The idea might be developed further by emphasizing how credit policy impacts and influences how credits are managed and administered.

No matter how skillfully a manager manages his loan procedures, bad debts may later arise, or sometimes the loan or prepayment terms may become unclear, according to Etloite (1989), ultimately reducing profitability. He stated that bad debts go through a questionable phase before the actual loss of money occurs, and there are many reasons why loans become unsatisfactory. Those reasons include, in his opinion:

- Customers and
- Being unable to operate their business profitably. The organization loses a key employee.
- A decrease in consumer demand for goods or services
- Excessive travel by traders or
- Living beyond your means or even unfortunate circumstances working against a particular company.

3. Empirical Background

The term "non-performing assets" (NPA) refers to a group of loans and advances that are in default because the borrower has failed to make the required payments for a predetermined amount of time. Profitability, asset growth, and client base expansion are the three core goals of banks. The bank's primary means of making money comes from the loans and advances it makes to customers. Even though it produces rewards, it may be said to be the most significant bank risk, particularly for commercial banks. The evaluation of a company's assets to determine the degree and scope of the credit risk attached to its operation is a key component of asset quality, a crucial aspect of bank management. Asset quality is a micro-prudential factor that affects the stability and success of commercial banks. It pertains to the left side of a bank's balance sheet and is concentrated on the loan quality that generates profits for the bank (Abata, 2014).

Numerous researchers have examined credit risk from various perspectives since it represents a substantial threat to banks' ability to operate. The control of credit risk can significantly reduce or even prevent bank failure. This is because the quality of risk assets and the credit judgments made ultimately define how successful a bank will be. Credit risk management offers a leading indicator of the stability of a bank's credit portfolio (McNaugton, 1994). Credit risk management offers a leading indicator of the stability of a bank's credit portfolio (McNaugton, 1994). Felix and Claudine's (2008) investigation examined the relationship between bank performance and credit risk management. Their results revealed that the relationship between return on equity (ROE) and return on assets (ROA), two metrics used by financial institutions to gauge profitability, was inverse, resulting in a decline in profitability.

Kithinji (2010) examined the impact of credit risk management on the bottom line of Kenya's deposit money banks. Data on credit volume, the percentage of non-performing loans, and profitability were gathered for the years 2004 to 2008. The findings suggested that factors other than credit and non-performing loans have an impact on profits because the quantity of credit and non-performing loans had little to no effect on the majority of Deposit Money Bank profitability. Epure and Lafuente (2012) examined how Costa Rica's banking industry fared from 1998 to 2007 when faced with risk. The research showed that non-performing loans have a negative impact on efficiency and return on assets, regulatory changes cause efficiency increases, risk explains bank inequalities, and the capital adequacy ratio has a positive impact on the net interest margin. According to Ahmed, Takeda, and Shawn's (2013) research, loan loss provision significantly improves the performance of non-performing loans; as a result, a rise in loan loss provision denotes an increase in credit risk and a decline in loan quality, both of which are detrimental to a bank's performance.

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structure. This summary of credit policymaking also considers additional issues, such as the type of credit issued and the terms under which it is granted. In the aforementioned definition, Bench makes an attempt to define the reach of credit policy. The idea might be developed further by emphasizing how credit policy impacts and influences how credits are managed and administered.

The many reasons why a loan obligation might not be paid back when it is due are what give rise to the risks that come with lending. Changes in customer demand or industry technology have the power to drastically alter a commercial firm's financial situation, which can turn a borrower who was formerly profitable into a loss-making enterprise. Long-lasting labor unrest, aggressive price cutting, or the loss of key management personnel can all seriously impair a borrower's ability to make loan repayments.

Loans and advances that are often difficult for borrowers to repay are called non-performing assets. In recent years, the problem of non-performing assets (NPAs) has received increasing attention. Despite the Banking Act of 1952, there have been several bankruptcies in Nigeria and non-performing loans and advances were precursors to these incidents. Many studies have described non-performing loans as bad loans that are highly unlikely to be repaid because they are not serviced as needed. In the banking system, default bond issues consist of an unstructured equity component and potentially an unstructured current component. Therefore, loans and advances are not always annual events but occur at different times during the year. They are often affected by the seasonality of the economy. However, they are also strongly influenced by short-term inflation, interest rates and the level of risk in areas where the economy is struggling. Profitability is a crucial metric in measuring the efficiency of a bank because the health of a bank is not determined by the size of the balance sheet but rather by the return on assets. However, if the bank's financial statements have not been changed, many indicators can be used to measure its performance. A number of measures have been adopted and implemented to reduce the risk of advanced assets. Among them are seven of the 25 essential principles for successful banking supervision established by the BASEL Committee on Banking Supervision in 1997. According to them, compliance with banking regulations and prudent lending are essential to maintaining a good asset. As a micro-factor of profitability, poor asset quality affects financial performance and the stability of the banking system. In Nigeria, the Banks and Other Financial Institutions Act, 1990 (BOFIA) regulates the activities of banks and imposes restrictions on bank lending to prevent non-performing assets and ensure asset quality. For example, section 18 prohibits personal interest on loans and advances to bank employees without disclosing the nature of the interest, and section 20 limits the amount of loans and advances from a single debtor to 20% of the shareholders' fund. BASEL I, II and III clauses complete this. Asset-liability mismatches have historically been a problem for Nigerian banks. Over the years, poor asset quality has been considered a problem in the banking sector. The Asset Management Partnership of Nigeria was established and N620 billion was invested in the banking sector following a 2009 discovery by a research group of the Central Bank of Nigeria that four years after consolidation, commercial banks in Nigeria had non-performing assets in excess of their capital base Loans and advances are one of the main components of banks' assets, and effective management of such credit portfolios has been difficult. Inadequate deposits from surplus to deficit sectors of the economy were not the root cause of many bank failures; instead, the credit portfolio was poorly managed. Industry is believed to be an important part of the country's economic growth. This is particularly evident in the area of financial intermediation, where corporate banks operate. However, previous studies in this area have shown that achievements in this area have been documented. Due to inefficiencies or inefficiencies in managing their credit portfolio, some banks find it difficult to meet their obligations to customers and owners, which may lead to bank insolvency or insolvency.

If the interest and/or principal payment is delayed by 90 days or more, or if the interest payments are capitalized, refinanced or delayed by 90 days or more according to the agreement, or if the payments are delayed by less than 90 days, the loan or advance is considered non-performing. However, there may be other good reasons to doubt whether payments will be made in full, such as the debtor filing for bankruptcy. Delinquent loans are often loans in which, contrary to the terms of the loan agreement, both the principal and the interest have not been paid for a very long time. Delinquent assets are any loan agreement that violates the basic terms of the loan agreement and interest payments. The number of non-performing loans and advances, therefore, measures the quality of the bank's assets (Tseganesh, 2012).

The main source of income for commercial banks is credit creation (Kargi, 2011). However, this exposes banks to significant credit risk. The Basel Commission on Banking Supervision (2001) defined credit risk as the potential loss of a loan either in part or in whole as a result of credit events. Credit risk affects the bank's operations internally. The more it is exposed to credit risk, the greater the probability that the bank will experience a financial crisis and vice versa. According to Ahmad and Ariff (2013), during the financial and banking crises, most banks and other economies such as Thailand, Indonesia, Malaysia, Japan and Mexico had large non-performing loans (NPL) and a significant increase in credit risk, which led to the closure of several banks in Indonesia and Thailand. Since the 1980s, the problem of non-performing loans has become a global and extremely important problem, as credit risks and non-performing loans have a negative impact on banking and the economy as a whole. Hou and Dickinson (2007) argue that many studies on the causes of bank failure have shown that asset quality is a statistically significant predictor of failure and that failed banking organizations always have high levels of non-performing loans and advances before failure. Therefore, to manage the credit portfolio and achieve the desired profit, the bank must pay sufficient attention to the aforementioned aspects.

NPAs (non-performing assets) play a crucial role in the economy since they have an impact on commercial banks' ability to provide financial intermediation services, which is their primary source of income (Klein, 2013). Bank failure and a slowdown in the economy are the direct results of a high number of non-performing assets in the banking sector. Ineffective bank monitoring and supervision, a lack of effective lender recourses, flaws in the legal system, and a lack of effective debt collection techniques are typically cited as the causes of non-performing loans (Adhikari, 2007).

By utilizing various ratios and a linear regression model of the econometric technique, a Time Series Data analysis of Non-Performing Assets and their growth, provisions, and link to the bank's overall profitability was undertaken (Lata, 2014). The empirical findings of the analysis showed that Commercial Banks' non-performing loan ratio is quite high and that they have held more than half of all NPLs in Bangladesh's banking sector over the past eight years. The researcher came to the conclusion that one of the key elements affecting a bank's overall earnings is NPL.

The non-performing Asset ratio (NPAR) shows the percentage of loans and advances that default. The Non-Performing Loan Ratio (NPLR) was found by Gizaw et al. (2015) to be the main measure of credit risk for commercial banks. They discover that NPLR significantly reduces profitability as assessed by Return on Assets (ROA). The ratio of non-performing to gross loans, however, has been proven to have a favorable impact on the financial performance of banks by Li and Zou (2014) and Alshatti (2015). In contrast to the results of the aforementioned study, Felix and Kargi (2011) and Kodithuwakku (2015) discovered that non-performing loans had a negative influence on profitability. Furthermore, according to Kithinji (2010), the percentage of commercial banks' profits is unaffected by the number of non-performing loans. The theory and the majority of the empirical literature predict a negative link between the non-performing loan ratio and the bank's profitability (ß1 0) despite the fact that there are contradicting pieces of evidence on this topic.

The impact of non-performing loans and other factors on the financial performance of commercial banks in Malawi's banking sector was investigated by Chimkono et al. (2016). Secondary data were collected for the seven-year period 2008-2014 and regression analysis was performed on them. The authors conclude that average loan interest rates, cost efficiency ratios and non-performing loan ratios significantly affected bank performance in Malawi. They argue that although the cash reserve ratio variable was positively correlated with bank efficiency, it was not statistically significant. One of the most important factors affecting the profitability of banks, especially in commercial banks, can be called non-performing loans (Non-performing Advances) because they are directly related to the creation of credit in the economy. Looking at the literature, the researcher found that previous studies only focused on finding out the impact of non-performing loans while not paying much attention to the impact of non-performing advances on the overall outcome. In addition, previous studies have identified the impact of non-performing loans on bank profitability by considering return on assets and return on equity while not considering the actual profitability of the bank. The relationship between non-performing assets and bank profitability remains unclear, especially in the Sri Lankan context. Therefore, this study focuses on the research problem:

- To what extent do non-performing assets affect the net profit of licensed commercial banks in Sri Lanka?

To address this research question, this study attempts to find out the effect of non-performing assets (non-performing loans) on the net profit of licensed commercial banks in Sri Lanka.

4. Materials and Methods

4.1. Conceptual Framework

Based on the cited literature, the researcher established a conceptual framework to depict the relationship between the variables in a methodical approach to ascertain the impact of non-performing assets on the overall profitability of licensed commercial banks in Sri Lanka.

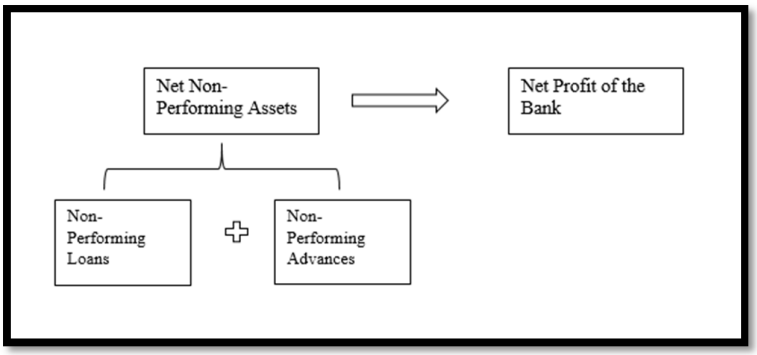

Figure 1: Conceptual Framework

According to figure 1, the study's dependent variable was the Net Profit of the Bank, while Net Non-Performing Assets (Non-Performing Loans + Non-Performing Advances) were the independent variable relevant to the study. The researcher relies upon secondary data sources in research to use the most precise data

4.2. Population, Sample and Sampling

Authorized Financial Institutions in the Sri Lankan financial system remain the study's population, while licensed or registered banks in Sri Lanka remain this research's target population. Licensed commercial banks in Sri Lanka are the study sample of this research, which is a smaller representation of the larger whole.

The population size is 131 authorized financial institutions in Sri Lankan financial system, including licensed commercial banks, licensed specialized banks, licensed financial companies, registered finance leasing establishments, authorized primary dealers, authorized money broking companies, and licensed microfinance intuitions. The sample

under consideration in the research is licensed commercial banks, which consist of 24 commercial banks which represent 18% of the Sri Lankan financial system. The sample has been selected using the convenient sampling technique to fulfill the objectives of the research.

4.3. Data Collection and Data Analysis

This research is predominantly based on secondary data sources to pool the most accurate data relevant to the study. The Central Bank of Sri Lanka's Economic Data Library is the main source of data for the study. The data have been purposively derived from the economic data library of the Central Bank of Sri Lanka according to the requirements of the research.

The research is focused on analyzing time series data regarding the overall profit of the Licensed Commercial Banks in Sri Lanka and Non-Performing Assets (Non-Performing Loans + Non-Performing Advances) using the EViews - Version 10 statistical software package. The regression analysis has been conducted to assess the relationship between the variables under consideration. Regression analysis is a technique for investigating and modeling the relationship between the response or dependent variable and explanatory or independent variables. The researcher has conducted a simple regression analysis with the aid of E-views – Version 10 to attain the objectives of the research.

5. Results and Discussion

The analysis has been conducted in terms of both descriptive and statistical analyses to fulfill the objectives of the study. The below table shows the basic descriptive statistics related to the data under the analysis of the study.

	Profit After Tax	**Net Non-Performing Assets**
Mean	55735.25	125484.8
Median	50129	95801.15
Maximum	125507	377622.7
Minimum	4795	34385.18
Std. Dev.	42905.87	97401.61
Skewness	0.334069	1.597504
Kurtosis	1.604469	4.49947
Jarque-Bera	1.994928	10.38041
Probability	0.368814	0.005571
Sum	1114705	2509697
Sum Sq. Dev.	3.50E+10	1.80E+11
Observations	20	20

Table 1: Basic Descriptives

Hypothesis:

- H0 = The collected data has been normally distributed
- H1= The collected data has not been normally distributed

The test results of the Jarque-Bera test assess the normal distribution of the data. The derived results of the test for both variables show that the data for both variables have been distributed normally (< 0.05), which leads to accepting the null hypothesis, concluding that the data of the model has been distributed normally within the given confidence interval level.

Correlation Coefficient	-0.69

Table 2: Correlation Coefficient Table

The correlation coefficient of the model shows a value of -0.69 (Approximately 0.7), which lead to conclude that there is a strong and negative correlation between the dependent and independent variable in the estimated model (> 0.6).

R-squared	**Adjusted R-squared**	**S.E. of Regression**
0.49	0.46	31578.61

Table 3: Model Summary

R can be identified as a measure that is available to measure the quality of the prediction of the dependent variable. The study identifies the measure of 'Net Profit.' In this test, the R = 0.49 (0.5) value represents the prediction level. The value of R2= 0.5 that the independent variables explain 50% of the variability of the dependent variable, 'Net Profit.' Even though the value of the adjusted R2 value differs from the R2 value, it shows a close value to the R2 value. The standard error of this test is 31578.61.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Net Non-Performing Assets (Millions LKR)	-0.31	0.074	4.13	0
C	17167.43	11703.56	1.47	0

Table 4: Results of Regression Co-efficient

The coefficient table shows the significance of the individual variables to the estimated model. Unstandardized coefficients indicate how much the dependent variable varies with an independent variable when all the other independent variables remain constant.

Hypothesis:

- H0 = There is no significant impact over the dependent variable by the independent variable.
- H1 = There is a significant impact over the dependent variable by the independent variable.

In this model, the unstandardized coefficient, ß0, the constant of the regression line is 17167.43 where P (0.00) < 0.05, which leads to rejecting the null hypothesis. This means there is a statistical significance in the constant. The unstandardized coefficient, ß1, for 'Net Profit' is -0.31 where P (0.000)> 0.05, which leads to rejecting the null hypothesis, which means there is a statistical influence over the dependent variable by the 'Net Non-Performing Assets.'

6. Conclusion and Recommendations

The findings of this research indicate that there is a negative relationship between the net profit and net non-performing assets of the commercial banks of Sri Lanka. Further, the variables under consideration have indicated a negative correlation, which leads to the conclusion of the existing negative relationship between the variables.

Finally, given that the assumptions of the simple linear regression analysis are satisfied, the fitted model is the most accurate technique to determine how the non-performing assets of the commercial banks in Sri Lanka affect the bank's overall profit. An expression for the fitted model is as follows:

Net Profit of the bank = 17167.43 – 0.31 Non-Performing Assets

The researcher further revealed that the Non-Performing Assets of Commercial Banks have significantly influenced the Net Profit of Commercial Banks.

The researcher recommends that future researchers focus on the other institutions in the financial sector of Sri Lanka to generate more diversified results as well as to gain a diversified overview of the behavior of the banks of the Sri Lankan Banking sector in relation to their credit risk in executing the financial operations.

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