

A study on Liquidity and Profitability of Private Banks in Sri Lanka.

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ABSTRACT

The recent crisis has underlined the importance of sound bank liquidity management. In response, regulators are devising new liquidity standards with the aim of making the financial system more stable and resilient. Liquidity is most significant discipline of Banks' Profitability. Liquidity maintenance is an operational tool that helps to determine 'how does a bank choose their liquidity assets?' bank liquidity maintenance is then the composition or structure of its liquidity assets. This Study aims to examine the impact of liquidity on profitability of banking sector in Sri Lanka from 2008 to 2012. To conduct this research, samples were selected from all commercial banks in Sri Lanka. After data were collected from secondary sources of those samples, these data were presented and analyzed by using correlation and regression tools. In this research, the researcher concluded about the hypothesis providing, then clarify the research findings, after that the researcher formed a final conclusion. Some important suggestions also were given for the future studies. According to the analyses, showed that liquidity ratio has strong positive correlation with return on assets. Otherwise there is no relationship between liquidity and banks' profitability. There is no significant impact of liquidity on profitability of banking sector in Sri Lanka.

Keywords: Liquidity ratios, Net Profit Ratio, Private Banks, Return on Assets, Return on equity.

Introduction

Liquidity plays a role in determining the profit level of the company, and maintaining liquidity is the key factor whether it is involved in the customer convenience and satisfaction. It should be keep adequate level if the management is likely to confront an uncertain environment but how low or how high is the basic question. The assets of the company can be financed by owner or the loaner and depositors. Maintains both liquidity and profitability decision is significant managerial decision, as it influences the shareholder return, risk, and customer satisfaction. Market share is also affected by these items. The bank has to plan its liquidity initially at the time of its promotion. Subsequently, whether the funds have to be raised, a profitability decision is involved

Literature Review

Theoretical and empirical literature on the determination of liquidity and profitability Assets and liabilities mismatch underpin currency crises and Models emphasize that imperfect financial structures combined with borrowing booms and asset price bubbles in emerging markets lead to large inflows of capital as long as yield differentials favor domestic assets by Chang and Velasco in 1998 and 1999, Calvo and Mendoza in 2000. Liquidity models place the responsibility for the crisis on a mismatch between short term assets and liabilities said by Dooley in 2000. The crisis in turn manifests as an explosion in the value of reserve currency denominated liabilities and pushes the consolidated banking sector deeper in the red Cespedes, Chang, and Velasco in 2004. Present a model in which this fear of financial collapse engenders "fear of floating". Calvo and Reinhart in 2002 and thus postpones the cessation of intervention in exchange markets. Velnampy, T. (2005) and Velnampy, T. (2013) indicators of profitability are Gross profit ratio (GPR); Net profit ratio (NPR); Return on assets (ROA); Return on equity (ROE) are taken into account for the study.

Normally banks profitability determinations research was made two types. One is a specific country determinant, another one is different countries determinant. A specific country in the determinant of bank profitability, which researches was made by Berger et al. in 1987, Berger in 1995, Barajas et al. in 1999, Naceur and Goaid in 2001, Naceur in 2003, Athanasoglou et al. in 2005 and also Aburime in 2008. The different countries studies made by Haslem in 1968, Short made in 1979, Bourke in 1989, Molyneux and Thornton who researched in 1992, Demirguc-Kunt and Huizinga made in 1999, Bashir made in 2000; Demirguc-Kunt and Huizinga in 2000; and Abreu and Mendes in year of 2002. Athanasoglou, Brissimis and Delis who were found A sound and profitable banking sector is better able to withstand negative shocks and contribute to the stability of the financial system in 2005. Havrylchuk et al. found a positive relationship between capital and profits of banks in 2006. An association between organizational growth and profitability, a study of commercial bank of Ceylon LTD Sri Lanka was made by Velnampy and Nimalathasan in 2008.

Based on the above literature, we can say that there are some studies about liquidity and profitability of banks in various countries, however a detailed study has not yet been conducted in Sri Lanka context, especially banking

sectors. Hence the present study is made on a Comparative Study of liquidity impact on Banks profitability in Sri Lanka from 2008 to 2012.

Data Collection

The main source of information gathered in this study is primarily based on secondary data collection over the sample period of 2008 to 2012. According to Hair, Bush and Ortinau (2003), secondary data can be defined as “data not gathered for the immediate study at hand but for some other reason”. Following sources have been identified as secondary data collection tools.

- Annual report of Banks
- Annual report of Colombo Stock Exchange
- Annual report of Central bank of Sri Lanka

Objectives

Through this study the researcher can get new ideas about market liquidity assets maintaining in banking sector and to improve banks profitability and can provide new ideas to modify any inefficient matters and can suggest any advantages and in future development.

This research is conducted with the intention of following objectives.

- A. To find out the relationship between liquidity and profitability private in Sri Lanka.
- B. To identify the liquidity and profitability of private commercial over the last 05 years during 2008-2012.

Sample Design

Here used sampling technique is convenience sampling technique. This comes under non probability sampling method. Based on the annual report of central bank of Sri Lanka, towel domestic licensed to commercial banks are registered under the Central bank of Sri Lanka. Those Banks are categorized under two sectors, Such as state banks and private banks. So we used sampling technique in private commercial banks. Samples are taken only from ten private commercial banks. Five banks are chosen as samples from out of ten private commercial banks through convenience sampling technique.

The Population of study (Banks' names)

01.Population
1. Commercial Bank of Ceylon PLC
2. DFCC Vardhana Bank Ltd
3. Hatton National Bank PLC
4. National Development Bank PLC
5. Nations Trust Bank PLC
6. Pan Asia Banking Corporation PLC
7. Sampath Bank PLC
8. Ceylon Bank PLC
9. Union Bank of Colombo PLC
10. Amana Bank Ltd



02.Samples
1. Commercial Bank
2. HattonNational Bank
3. Nations Trust Bank
4. Sampath Bank
5. 5.Pan Asia Bank

This selected samples banks are playing major role in the Sri Lankan economy and also a banking sector of Sri Lanka. Commercial Bank PLC and Sampath bank PLC are leading banks in Sri Lanka. Hatton National Bank PLC is mast popular bank of our nation. It has so many branches over all of the country including north and east more than twenty years. Ceylon Bank PLC and Nation Trust Bank PLC are popular banks in Sri Lanka rather than other banks.

Methodology

Descriptive Statistics

Descriptive statistics is the discipline of quantitatively describing the main features of a collection of data or the quantitative description itself. They provide a useful summary of security returns when performing empirical and analytical analysis, as they provide a historical account of return behavior. Although past information is useful in any analysis, one should always consider the expectations of future events. Descriptive statistics include mean, standard deviation, minimum and maximum values of the variables.

Correlation Analysis

Correlation analysis is the statistical tool that can be used to describe the degree to which one variable is linearly related to another. In order to carry out the research techniques that correlation analysis are being used to find out the relation between the variables. This is concerned with describing the strength of the relationship between two variables by measuring the degree of “scatter” of the data values. This is achieved through a correlation of co-efficient. Normally represented by symbol “r” it is a number which lies between -1 and +1.

This value is between negative one to positive one ($-1 \leq r \leq +1$).

A value of $r=0$ signifies that there is no correlation present, while the further away from 0 (towards -1 or +1) r is, the stronger the correlation. The co-efficient of correlation (r) takes the value from +1 to -1 (including plus and minus one). Therefore, the correlation co-efficient expresses the following pattern of relationship.

- Positive perfect relationship $r = +1$
- Negative perfect relationship $r = -1$
- Strong positive relationship $+0.8 \leq r < +1$
- Strong negative relationship $-0.8 \leq r < -1$
- Moderate positive relationship $r = +0.5$
- Moderate negative relationship $r = -0.5$
- Weak positive relationship $+0.1 \leq r < +0.3$
- Weak negative relationship $-0.1 \leq r < -0.3$
- No relationship $r = 0$

Correlation analysis is the statistical tool that can be used to describe the degree to which one variable is linearly related to another. In order to carry out the research techniques that correlation analysis are being used to find out the relation between variables.

This method is used to interpret the pattern of relationship between two variables, or the strength of the relation. The most common measure of correlation predictability is person coefficient of correlation (r). The value of correlation coefficient is calculated by the following formula:

$$r = \frac{n \sum xy - \sum x \sum y}{\sqrt{[n(\sum x^2) - (\sum x)^2][n(\sum y^2) - (\sum y)^2]}}$$

Where,

r = Correlation co- efficient

y = Depended variable

x = Independent variable

n = No of firms

Here, Independent variable is only one Liquidity ratio. And depended variables are

Net profit ratio, Return on average assets, and Return on equity.

The value of coefficient calculated through above formula can be anywhere between -1 and +1 ($+1 \geq r \geq -1$).

In this study the correlation co-efficient analysis was under taken to find out the relationship between liquidity and bank profitability.

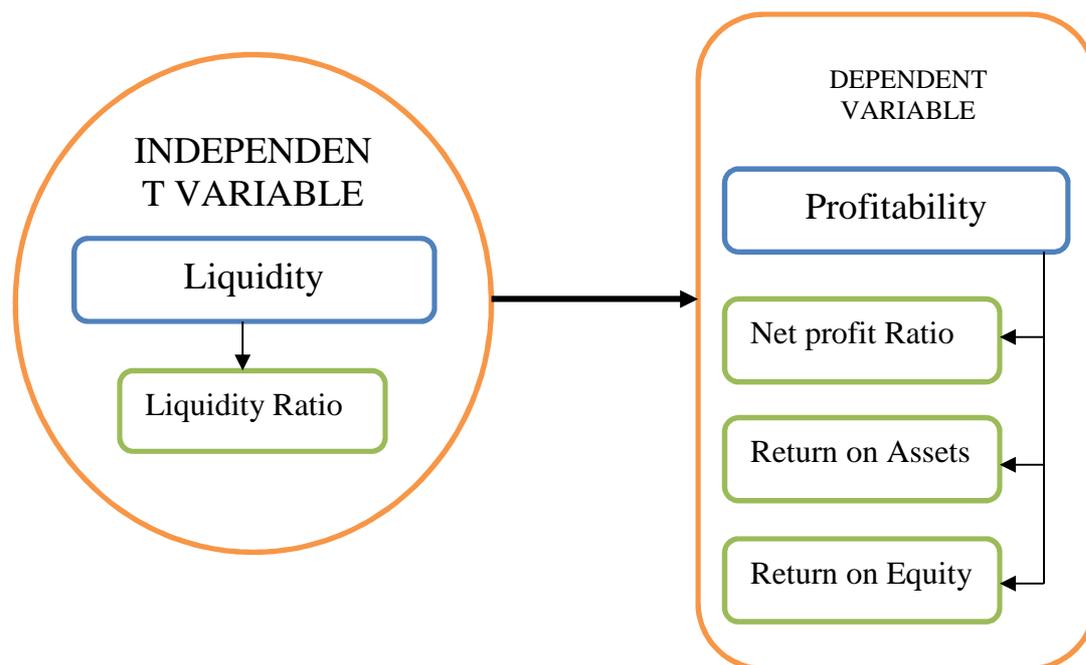
Hypotheses

Possible hypotheses are formulated based on conceptualization of the research problem and research topic. Since the objective of this study is to examine the Relationship between liquidity and Banks profitability, finally hypotheses are examined whether it is accepted or not. This research is conducted based on the following hypothesis.

H₁:- There is a relationship between liquidity and Bank's profitability.

Conceptualization

The conceptualization is known as framework of key concepts. It shows the relationship between dependent variables and independent variables. Here only one variable is independent variable which is Liquidity Ratio. Three variables are dependents which are Net Profit Ratio, Return on Assets Ratio, Return on Equity Ratio. According to the research problem, conceptual model is defined as follows:



Descriptive Statistics

Table :Descriptive Statistics of Banking Sector

	Minimum	Maximum	Mean	Std. Deviation
Liquidity Ratio	22.64	33.91	26.0760	4.54799
Net profit ratio	7.19	15.05	11.2260	3.19823
Return on Assets	1.18	1.86	1.4580	.27590
Return on Equity	16.00	21.02	18.7900	1.93342

Source: Computed Data

Descriptive statistics describe patterns and general trends in a data set. It is used to examine variables at a time. In accordance with the results of the descriptive statistics shown in the Table minimum value, maximum value, means and standard deviation of liquidity ratio, net profit ratio, return on assets, and return on equity Private Banks

Minimum and maximum values of liquidity ratio of Private Banks are 22.64 percentages and 33.91 percentages respectively. Mean value of liquidity ratios as 26.08 percentages. And also standard deviation is 4.54799. Minimum and maximum values of Net profit ratio of Private Banks are 7.19 percentages and 15.05 percentages respectively. Mean value of liquidity ratios as 11.226 percentages. And also standard deviation is 3.19823

Minimum and maximum values of return on assets ratio of Private Banks are 1.18 percentages and 1.86 percentages respectively. Mean value of return on assets ratios as 1.458 percentages. And also standard deviation is 0.2759. Minimum and maximum values of Return on Equity ratio of Private Banks are 16 percentages and 21.02 percentages respectively. Mean value is 18.79 percentages. And also standard deviation is 1.93342.

Correlation Analysis

Table 4.5.1: Correlation Analysis of Variables

		Liquidity Ratio	Net Profit Ratio	Return On Asset	Return On Equity
Liquidity Ratio	Pearson Correlation	1			
	Sig. (2-tailed)				
Net Profit Ratio	Pearson Correlation	-.097	1		
	Sig. (2-tailed)	.835			
Return On Asset	Pearson Correlation	.784*	.186	1	
	Sig. (2-tailed)	.037	.690		
Return On Equity	Pearson Correlation	.547	-.614	.590	1
	Sig. (2-tailed)	.204	.142	.163	

*Correlation is significant at the 0.05 level (2 Tailed)

When interpreting the Pearson's correlation shown in the table, it says that, there is a weak negative relationship between liquidity ratio and net profit ratio at -0.097. There is no significant relationship between liquidity ratio and net profit ratio at 0.819. There is a strong positive relationship between liquidity ratio and return on assets with correlation is significant at the 0.05 level. Further, there is moderate positive relationship between liquidity and return on equity at 0.547. There is no significant relationship between liquidity ratio and return on equity at 0.268 significant.

Further, there is a weak positive relationship between net profit ratio and return on assets with 0.186. There is no significant relationship between net profit and return on assets at 0.690 significant. Even though both net profit ratio and return on asset ratio independences variable. And also there is a moderate negative relationship between net profit ratio and return equity ratio. But there is no significant relationship between net profit and return on assets at 0.142 significant. Even though both net profit ratio and return on equity ratio independences variable. Further, there is a moderate positive relationship between return on assets and return on equity with 0.590. There is no significant relationship between return on asset ratio and return on equity ratio at 0.163 significant.

Hypotheses Testing

No	Hypotheses	Status
H ₂	There is a relationship between liquidity and profitability.	Partially Accepted
H _{2a}	There is a relationship between liquidity and net profit.	Rejected
H _{2b}	There is a relationship between liquidity and return on assets.	Accepted
H _{2c}	There is a relationship between liquidity and return on equity	Rejected

H_{2a}:- There is a relationship between liquidity and net profit.

Correlation coefficient between liquidity and net profit is $r = -0.097$, this shows that there is a weak negative relationship between liquidity and net profit. But there is no significance. So H_{2a} is rejected.

H_{2b}:- There is a relationship between liquidity and return on assets.

Correlation coefficient between liquidity ratio and return on assets is $r = 0.784$, this shows that there is a strong positive relationship between liquidity and return on assets. Hence it illustrates that when liquidity increases, profitability also increases at a high level. Therefore, liquidity is correlated with profitability of private banking sector in Sri Lanka in high level. So, this H_{2b} hypothesis is accepted.

H_{2c}:- There is a relationship between liquidity and return on equity.

Correlation coefficient between liquidity and return on equity is $r = 0.547$, this shows that there is a moderate positive relationship between liquidity and return on equity. Even though there is no significance. So, this H_{2c} hypothesis is rejected.

H_2 - There is a relationship between liquidity and profitability

Based on above hypothesis H_{2a} and H_{2c} are rejected but H_{2b} is accepted so that the reason over all H_2 hypotheses is partially accepted in this study.

Findings of the Study

According to the ratio analysis, Net Profit (NP) of Private Banks was increasing this ratio every year than previous year of this study. NP of Private Banks was a linear increase over the years from 2008 to 2011. Return on Assets (ROA) of Private Banks was increasing every year than previous year of this ratio. Return on Equity (ROE) of Private Banks has smoothly increased of this ratio over the period of this study. There is no any sequence changes of Liquidity Ratio (LR)

According to the correlation analysis, there is a strong positive relationship ($r = 0.784$) between Liquidity ratio and return on assets in 5% significant level. Otherwise there is no any relationship between Liquidity and Net profit. And also there is no any relationship between Liquidity and return on assets.

Recommendations

According to this study there is no relationship between Liquidity and Banks' Profitability. And also Liquidity does not impact on Banks' Profitability. So that the reason. Banks must be considered the other factor for determine or increase the Banks' Profitability

The following suggestions are recommended to increase the Banks' Profitability based on liquidity maintenance.

- There is no any relationship between liquidity and Banks' Profitability so when a Banks want to increase its profitability, Bank can be maintained lower level of liquidity assets.
- There is no any negative relationship between liquidity and Banks' Profitability so bank can maintain any level of liquidity assets. Even Banks must be maintained optimum level or require level of liquidity assets.
- There is no any relationship between liquidity and Banks' Profitability. So that the reason. Banks must be considered the other factor for determine or increase the Banks' Profitability. Such as follow:
 - ✓ Consider the capital stature of the Banks. Because, this is one of the major factor of determination of Banks' Profitability.
 - ✓ Identifying weaknesses of investment such as loan, pawning, Treasury bill, Treasury bonds and etc may be best one to improve the Banks' Profitability, because it indicates the area which decision should be taken.
 - ✓ Motivating the Depositor to help to achieve the high level of Banks' Profitability
 - ✓ Political changes are very important factor in the economic. It is also determine the Banks' Profitability. Therefore, political should possible to increase the performance of the Banks Sectors.
 - ✓ Inflation and exchange rate also affect the Banks' Profitability. So, government should consider the economic growth to control the inflation.

Suggestions for Further Research

The researcher has experiencing the ability to provide suggestion and recommendation for further researcher to gain more worthy if any research will be conducted by them in this field. Some of the suggestion and recommendations are given below.

- Here the Banks' Profitability is computed based on Liquidity but too many factors or measures have impact on Banks' Profitability. So the result will be further valuable when researcher considers various kinds of measures.
- There are 22 commercial banks are operated in Sri Lanka but this study has taken only seven banks are taken as sample so it consist of small number of firms. To generalize the analysis the sample size would be increased.
- Only some methods are used to test hypothesis such as correlation & regression. Further the researcher can add much variety of techniques to generalize their findings such as ANOVA, descriptive statistics and etc.
- Only secondary data are collected to analysis to do this research. Further researchers may use primary data by visiting to every Banks.
- This study consider only from 2008 to 2012. There is a research gap previous years.

Going forward, this study could serve as a stepping stone for additional work. One could apply the current framework to additional countries, perhaps focusing on those with and without preexisting bank liquidity

requirements. One could also explicitly model the determinants of bank liquidity asset holdings or go one step further and establish a general equilibrium model including bank profitability and liquidity. In any event, the current Study serves as an initial step, highlighting an important, if elementary, relationship, relevant to the regulation of banks.

Conclusion

This Study presents empirical evidence regarding the impact of liquidity on profitability of the banking sector in Sri Lanka, over the period of 2008 to 2012. In short, results suggest that a nonlinear relationship exists, whereby profitability is improved for banks that hold some liquid assets, however, there is a point beyond which holding further liquid assets diminishes a banks' profitability, all else equal. Conceptually, this result is consistent with the idea that funding markets reward a bank, to some extent, for holding liquid assets, thereby reducing its liquidity risk. However, this benefit is can eventually be outweighed by the opportunity cost of holding such comparatively low-yielding liquid assets on the balance sheet.

Preliminary results in this study also suggest that Sri Lankan banks may have needed to hold less liquid assets over the estimation period than Stranded rate of liquidity requirement. For banks in order to optimize profits. More generally, this Study marks a first attempt to empirically address the relationship between liquidity assets and bank profitability. In interpreting the estimation results, it should be kept in mind that this work uses a reduced form model and, despite econometric adjustments, may not fully account for endangerment between variables. This is particularly important in terms of discussing any optimal level of liquid asset holdings relative to profits. Even though availability of liquidity asset must be maintained.

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