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Capital Adequacy Requirements and Profitability: An Empirical Study on Banking Industry in Sri Lanka

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Abstract:
In Sri Lanka, capital adequacy requirements conforming to Basel III was implemented in June 2017. The Central Bank of Sri Lanka introduced the internal capital adequacy assessment process in 2013, which facilitated the introduction of Basel III. In this paper an attempt has been made to study the impact of capital adequacy requirements on profitability of banking industry in Sri Lanka. The main objectives of this study were to identify the relationship between the capital adequacy requirements and profitability and to examine the effect of capital adequacy requirements on profitability of banking industry in Sri Lanka. The study adopted a descriptive explanatory research design. Capital adequacy ratio, core capital ratio, asset quality, risk-weighted assets to total assets ratio, tier 1 capital to total assets were used as the proxies for the capital adequacy requirements. Non-interest income to average assets, net interest margin and return on assets were used as the proxies for the profitability. The results of the multiple regression analysis shown that capital adequacy ratio had a positive significant relationship with Non-interest income to average assets. Tier 1 capital to total assets had a negative significant relationship with Non-interest income to average assets. Asset quality had a negative significant relationship with net interest margin. Other factors had insignificant relationship with dependent variables.

Keywords: Capital Adequacy Ratio, Basel III, Core Capital Ratio, Sri Lanka