

Impact of Income Diversification on Financial Performance of Licensed Commercial Banks in Sri Lanka

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Abstract

Licensed commercial banks are the backbone of Sri Lanka's financial system, holding more than 55% of the total assets in the sector and playing a vital role in ensuring price and economic stability. During the economic crisis, income diversification has emerged as a critical strategic tool for sustaining profitability and resilience. This study investigates the impact of income diversification, measured using the Herfindahl-Hirschman Index (HHI), on the financial performance of Sri Lankan commercial banks over the period 2014 to 2024. The analysis placed special emphasis on the shift towards fee-based income as a means of reducing reliance on traditional interest income, thereby mitigating risks associated with interest rate volatility and economic instability. Financial performance is measured using Return on Assets and Return on Equity, with non-performing loans and firm size included as control variables. A sample of 10 licensed commercial banks was selected using a random sampling method. The study applied multiple regression analysis supported by descriptive and correlation techniques. Findings reveal that income diversification has a significant negative effect on Return on Assets while significant positive effect on Return on Equity. Further, results showed non-performing loans significantly impact Return on Assets while it does not impact on Return on Equity, highlighting the sensitivity of asset returns to non-performing loans. The results underscore that, in times of economic distress, revenue diversification particularly through the expansion of fee-based services can strengthen banks' financial resilience, stabilize earnings, and reduce vulnerability to macroeconomic shocks. The study recommends that bank management and policymakers encourage broader adoption of diversification strategies to ensure long-term stability and performance in the Sri Lankan banking sector.

Keywords: commercial banks, financial performance, herfindahl-hirschman index, income diversification