The Impact of Ownership Structure on Financial Performance of Commercial Banks in Sri Lanka

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Abstract

The banking sector of a country is the backbone of its financial system. At present, different types of ownership structures are observable in the Sri Lankan banking sector. This study seeks to identify the impact of ownership structure on financial performance in Sri Lankan commercial banks. The ownership structure of commercial banks can take three forms: state or public ownership, domestic private ownership, and foreign ownership. Data were collected from fifteen commercial banks of Sri Lanka during 2015-2020 through annual reports. Results show that there is a significant impact of ownership structure on the financial performance of commercial banks. Further, foreign banks outperform domestic private banks and state-owned banks while private domestic banks outperform state-owned banks.

Keywords: *domestic private ownership, foreign ownership, financial performance, ownership structure, state-ownership*

1. Background

Financial restructuring in Sri Lanka began in the late 1980s, following open economic policies and associated financial reforms (Edirisuriya, 2007). These reforms affected the structure of the banking sector by reducing state banks' monopoly in commercial banks and generating significant improvements in banking activities (Seelanatha & Wickremasinghe, 2009). There are two state-owned, 11 domestic private-owned, and 11 foreign-owned banks in the licensed commercial banking sector (CBSL, 2020). According to Zeitun and Gang (2007), ownership structure has a significant impact on the financial performance of firms.

Existing literature provides contradictory results about the impact of ownership on financial performance. For instance, Hasan and Marton (2003) show that foreign banks have higher performance than their domestic counterparts, and

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Figueira et al. (2009) confirm the opposite of this making the findings in this area inconclusive. Moreover, many research studies in this area have been conducted in the developed and the middle-eastern contexts. In this light, most of these findings cannot be applied to the Sri Lankan context as the impact of ownership is different from developing countries to developed countries (Hasan & Marton, 2003; Demirgüç-Kunt et al., 1999). Moreover, only a few studies have been conducted in Sri Lanka in this area, of which the results are contradictory (Ekanayake & Premerathne, 2016; Fernando & Nimal, 2014). Thus, this study was carried out to assess the impact of ownership structure on the financial performance of institutions listed in the banking sector of Sri Lanka.

2. Literature Review

This study focuses on two theories concerning the impact of ownership structure on the financial performance of commercial banks - agency theory and public choice theory. According to Agrawal and Knoeber (1996), managers are less likely to engage in stringent profit-maximizing where there is poor monitoring by shareholders. When managers are not the owners of the company, conflicts of interest between agent and principle arise because of self-interest (Fama & Jensen, 1983). The public choice theory states that state-owned enterprises perform poorly than their privately-owned counterparts due to substantial political influences. Lack of monitoring and advancement of political agendas in state-owned organizations lead to poor performance of state-owned enterprises (Berger et al., 2005). In private firms, managers have more incentives than state enterprises to pursue the owner's objectives.

Owner identity is determined as public, private, and foreign-owned, based on the largest shareholder (LaPorta et al., 2002). LaPorta et al. (2002) show that the state ownership discourages the overall growth of the country. According to Gupta (2005), the state ownership hurts the firm's profitability, productivity, and investments. Jiang et al. (2013) and Berger et al. (2005) find that the banks owned by the government have poor performance in the long run than other banks. However, Figueira et al. (2009) state that state-owned banks perform effectively than privatized banks in developing countries.

Das and Ghosh (2009) and Haque et al. (2008) show that privately owned banks are more efficient than their public sector counterparts. Moreover, Wanniarachchige and Uddin (2011) show that foreign banks perform better than their domestic counterparts in Sri Lanka, India, and Bangladesh. They find that foreign banks have access to cheaper international funds because of their international linkages. Bonin et al. (2005) and Hasan and Marton (2003) state that foreign banks always operate efficiently. According to Micco et al. (2009), foreign banks tend to be characterized by high profitability and lower overhead costs than state-owned banks of developing countries. Many studies have shown that foreign-owned banks provide better service than other banks (Bonin et al., 2005; Demirgüç-Kunt et al., 1999).

3. Methodology

Through simple random sampling, 15 commercial banks were selected out of 24 licensed commercial banks operating as of 30th June 2020. Data were collected through audited annual reports of the selected banks (Rahman and Reja, 2015). Return on Assets (ROA) (Ekanayake & Premerathne, 2016; Fernando & Nimal, 2014) and Net Interest Margin (NIM) (Ekanayake & Premerathne, 2016; Demirgüç-Kunt et al., 1999) were used to measure bank performance. Based on Rahman and Reja (2015), this study categorized ownership into three groups: state, domestic private, and foreign. One-way ANOVA was used to assess the impact of ownership on the financial performance of commercial banks (Wanniarachchige & Uddin, 2011).

$$FP_{ij} + \mu + \tau_{1State} + \tau_{2\ Private} + \tau_{3\ Foreign} + \varepsilon_{ij} \text{ --------- } (1)$$

In the equation (1), *FP* denotes financial performance, μ denotes the grand mean, τ stands for the deviation in each group from the grand mean. Finally, *ε*, *i* and *j* denote random error, individual banks, and ownership groups, respectively.

4. Findings and Discussion

Descriptive statistics for NIM and ROA show that foreign banks have the highest NIM and ROA ($M = 0.052$, $M = 0.200$), whereas the state banks show the smallest NIM and ROA ($M = 0.032$, $M = 0.110$). Results of one-way ANOVA (Table 1) show that state-owned banks, domestic private banks and foreign banks have a statistically significant effect on ROA [$F(2, 81) = 19.70$, $p < .001$, $\eta^2 = .25$]. Similarly, the state-owned banks, domestic private banks and foreign banks have a statistically significant effect on NIM [$F(2, 81) = 20.77$, $p < .001$, $\eta^2 = .38$]. This complements the findings of Zeitun and Gang (2007) that ownership is a determinant of performance.

The above analysis was followed by the Games-Howell post hoc test for determining ROA variances and NIM variances among ownership groups. Games-Howell test for ROA revealed that foreign-owned banks perform higher on ROA than the state-owned banks (mean difference = 0.009, $p < .001$) and domestic private banks (mean difference = 0.008, $p < .001$). Moreover, the Games-Howell test for NIM revealed that foreign-owned banks perform higher on NIM than the state-owned banks (mean difference = 0.019, $p < .001$) and domestic private banks (mean difference = .013, $p < .001$). At the same time domestic private banks significantly outperformed the state-owned banks (mean difference = 0.006, $p < .001$). Haque et al. (2008) and Fries and Taci (2005) show similar findings where domestic private banks outperform state-owned banks. This could be because private domestic banks have a better balance of their operational processes. According to results, the state-owned banks are the least performing banks in Sri Lanka. This result agrees with the public choice theory, which indicates that the state-owned enterprises poorly perform than their privately-owned counterparts due to substantial political influences and operational inefficiencies. Studies conducted by Shaban and James (2018) and Berger et al. (2005) also found that the state-owned banks are the least performing banks.

Table 1: ANOVA Results and Games-Howell Post-Hoc Test Results

(I) Ownership	**(J) Ownership**	**Mean Difference (I-J)**	***p***	**95% CI**	
				Lower Bound	**Upper Bound**
ROA [$F(2, 81) = 19.70$, $p < .001$, $\eta^2 = .25$]					
State-Owned	Domestic Private	-.0015	.226	-.0038	.0007
	Foreign Owned	-.0095***	.000	-.0139	-.0052
Domestic Private	State-Owned	.0015	.226	-.0007	.0038
	Foreign Owned	-.0080***	.000	-.0122	-.0038
Foreign Owned	State-Owned	.0095***	.000	.0052	.0139
	Domestic Private	.0080***	.000	.0038	.0122
NIM [$F(2, 81) = 20.77$, $p < .001$, $\eta^2 = .38$]					
State-Owned	Domestic Private	-.0065***	.000	-.0102	-.0029
	Foreign Owned	-.0197***	.000	-.0269	-.0126
Domestic Private	State-Owned	.0065***	.000	.0029	.0102
	Foreign Owned	-.0131***	.000	-.0204	-.0059
Foreign Owned	State-Owned	.0197***	.000	.0126	.0269
	Domestic Private	.0131***	.000	.0059	.0204

Notes: The symbol (***) indicates statistical significance at 1 percent

These results highlight that foreign banks outperform domestic private banks and the state-owned banks. The findings of Wanniarachchige and Uddin (2011), Bonin et al. (2005), and Hasan and Marton (2003) also show that foreign banks perform better in their studies. This could be because foreign banks are better furnished with resources and capabilities through their international bank network, which supports them financially and logistically.

5. Conclusion

This research examines the impact of ownership structure on the financial performance of listed commercial banks of Sri Lanka. Findings show that different ownership structures have different degrees of impact on ROA and NIM. According to the study, foreign banks outperform domestic private banks and the state-owned banks. On the other hand, the state-owned banks are the least performing banks in Sri Lanka. This study will add to the extant knowledge on ownership structure and performance of the banking sector. Further, it will provide insights for policymakers, investors, and other stakeholders. However, there are few limitations of the study. It is limited to Sri Lankan commercial banks when the overall financial system of Sri Lanka has licensed specialized banks, leasing companies, investment banks, and insurance companies. Further, it focuses only on financial performance, which is measured using ROA and NIM. Future studies have the opportunity to venture into this research area by addressing these limitations.

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