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Systematic Risk Management and Profitability: A Case Study of Selected Financial Institutions in Sri Lanka

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Abstract - The main objective of the study is to identify the impact of Systematic risk management on Profitability, during 2007 to 2011 (05 years). In the present study, Systematic Risk Management [i.e., Degree of Financial leverage (DFL) and Degree of Operating leverage (DOL) as independent variable and Profitability (i.e., Net Profit, Return on Capital Employed (ROCE) and Return on Equity (ROE)] as the dependent variable are considered. In order to select the sample, convenience sampling techniques method is used. The study suitably used both secondary data. Operational hypotheses are formulated, results revealed that systematic risk management has a positive association($r = 0.755$, $p<0.05$) with Profitability. Further, Systematic risk management is enhanced by DFL and DOL in the selected financial institutions where the beneficial impacts are observed on profitability. Therefore, they have to pay more attention for tuning systematic risk management techniques. This study would hopefully benefit the academicians, researchers, policy-makers and practitioners of Sri Lanka and other similar countries through exploring the impact of systematic risk management on profitability, and pursuing policy to improve the current status of it.

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SYSTEMATIC RISK MANAGEMENT AND PROFITABILITY A CASE STUDY OF SELECTED FINANCIAL INSTITUTIONS IN SRI LANKA

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I. Background And Objectives

Research findings presented in the finance and accounting literatures have indicated a trend towards more keen approach in risk management by firms over time. Especially financial institutions are business. Managing the systematic risk at the optimum level is very essential to keep the performance at satisfactory level [1]. There are lots of different types like Business risk, Credit risk which are associated in a business Marcus (2005). In present study the following types are getting priority as per the research problem. In one sense risk can be categorized in to systematic and unsystematic risk. Unsystematic risk is a type of risk that depends on internal business factors and can be minimized through mechanism or designing an effective portfolio. It can be hedged but cannot be diversified completely away. In fact, systematic can be thought of as diversifiable risk [2]. Financial institutions assume this type of risk whenever assets owned or claims issued can change in value as a result of broader economic conditions. As such, systematic risk comes in many different forms such as, as interest rates change, different asset have somewhat different and unpredictable value responses. Energy prices affect transportation firms' stock prices and real estate values differently. Large scale weather effects can strongly influence both real and financial asset values for better and worse. The Main objective of the study is to find out the impact of systematic risk management on Profitability in finance intuitions in Sri Lanka. To achieve main objective, the following sub objectives are considered.

- To address the association between systematic risk management and Profitability
- To give some meaningful suggestions in order to enhance risk management practices in the financial institutions in Sri Lanka.

Literature Review and Hypotheses development

Plentiful works of early canvassers in risk management were found in the USA, UK and India [3]. The trend towards the adoption of more stylish systematic risk management created an interesting area for researchers to investigate: whether such systematic risk management performs leads to better profitability. Study [4] found that the mere adoption of systematic risk management techniques increase the performance. However, two studies proved otherwise [5,6]. Given the mix results over the years, this study seeks to provide further evidence on the degree of systematic risk management and profitability in Sri Lanka. Based on Literatures following hypotheses is formulated for the validity of the Literature.

H1: Systematic risk management is positively associated with Profitability

H2: Systematic risk management has an impact on Profitability

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II. Research Design And Methods

a) Sampling Techniques

The study use data of listed companies in the Colombo Stock Exchange (CSE), Sri Lanka. In order to select the sample, convenience sampling techniques method is used. The sample size is 10 Institutions illustrated given in the table 1 below

Table 1 : Sampling Techniques

S.No	Name of the Company
01	Sampath Bank
02	Commercial Bank of Ceylon Plc
03	National Development Bank
04	Hatton National Bank
05	Seylan Bank
06	Nation Trust Bank
07	DFCC
08	People Leasing Plc
09	LB Finance
10	Central Finance Plc

b) Mode of Analysis

In the present study, we analyze our data by employing correlation and regression analysis. The following table-2 shows the variables and their measures.

Table 2 : Variables and Their Measures

Variables	Measures
DFL	% Changes in EPS / % Change in EBIT
DOL	% Changes in EBIT / % Changes in Sales
Net Profit	Net profit / Sales X 100
ROCE	EBIT / Capital Employed X 100
ROE	PAT / Equity X100

c) Research Model

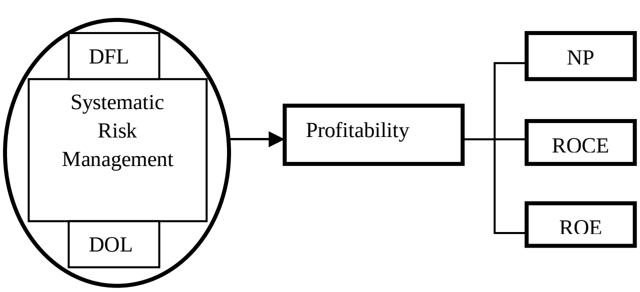

Fig. 1: Research Model

From the research model, the following equations are formulated.

$Y= \beta + \beta_1(X_1) + \beta_2(X_2)$

$NP= \beta_0 + \beta_1(DOL) + \beta_2(DFL)$……………………..Model – I

$ROCE= \beta_0 + \beta_1(DOL) + \beta_2(DFL)$…………….. Model – II

$ROE= \beta_0 + \beta_1(DOL) + \beta_2(DFL)$………………..Model – III

III. Findings And Conclusions

According to the empirical results of this study, the researchers can drive the conclusions regarding the impact of systematic risk management on profitability. Correlation analysis revealed that there is a positive association between Net Profit and DOL and DOF (0.312 & 0.354). ROCE also has direct association with DOL and DFL at 0.519 and 0.612 and respectively. Similar, there is a moderate positive association between ROE and DOL and DFL (0.419 & 0.567). It reflects the high financial cost management leads to better Profitability.

Financial institutions in Sri Lanka mostly depend on the debt capital. Therefore, they have to pay interest expenses much. The well-developed bond market is viewed as the primary reasons for the observed relationship. The firms don't have efficient investment. Therefore, their investment not enough to increase the profitability and financial benefits. Due to this reason net profit has weak relationship with DOL and DFL.

Regression analysis revealed that R2 value is 0.57 which indicated that systematic risk management impact on 57 percentages.

a) Hypotheses Testing

Here the hypotheses of the present study are tested with the help of the proposed models.

H_1: Systematic risk management is positively associated with Profitability.

It is focused on the point of view of correlation between the systematic risk management and profitability ($r= 0.755$, $p<0.05$). Therefore H1 is accepted.

H_2: Systematic risk management has an impact on Profitability.

It can been seen that from the regression analysis which revealed that R2 is 0.57 it means that systematic risk management has an impact on profitability at the rate of 57 percentage which is significant at 5 percent level. Therefore H2 is accepted.

b) Suggestions and Recommendations

The following suggestions are recommended to increase the institutional Profitability based on systematic risk management.

- Profitability standards should be established and communicated to the investors. This will help investors to achieve the standard and take better investment decisions.

- Identifying weaknesses of risk management may be best one to improve the firm's Profitability, because it indicates the area which decision should be taken.
- Motivating the risk mangers to help to achieve the high level of firm's financial performance.
- Equity capital should be increased. Because it help to increase the Profitability measures. Due to this, financial performance is stimulated.
- Political changes are very important factor in the share market. It is also determine the Profitability.
- Therefore, political should possible to increase the Profitability of the listed Institution.
- Inflation and exchange rate also affect the listed company's Profitability. So, government should consider the economic growth to control the inflation.
- Owners haven't enough capital to achieve firm's Profitability. Therefore banks and government should promote facilities to increase performance.

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