

Loan-to-Deposit Ratio and Bank Profitability: Empirical Evidence from Licensed Commercial Banks in Sri Lanka

G. Weerasinghe 

Department of Economics, University of Sri Jayewardenepura, Sri Lanka

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Corresponding Author: G. Weerasinghe | E-Mail: gaminiw64@sjp.ac.lk

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ABSTRACT

Banking industry contributes significantly to economic development through savings mobilization, credit provision, and the maintenance of financial stability. In Sri Lanka, Licensed Commercial Banks (LCBs) play vital role for the country's financial system through their deposit mobilization and lending activities. An economic instability, inflationary pressures, liquidity constraints, growing level of non-performing loans created considerable challenges of sustaining bank profitability, an effective management of loans and deposits has become a critical concern for commercial banking institutions, this study investigates the impact of Loan-to-Deposit Ratio (LDR) on the profitability of Licensed Commercial Banks in Sri Lanka. A quantitative research approach was employed using secondary data obtained from the published annual reports of ten selected Licensed Commercial Banks in Sri Lanka covering the period from 2005 to 2021. Bank profitability was measured using Return on Assets (ROA), while the Loan-to-Deposit Ratio (LDR) was utilized as the primary independent variable. Furthermore, Non-Performing Loans (NPL) and Bank Size (BS) were incorporated as control variables. The relationships of LDR and bank profitability was examined using descriptive statistics, correlation analysis, and panel regression techniques. Based on the results by Hausman test, the Random Effects Model was selected as the most appropriate estimation model. The findings indicate that the Loan-to-Deposit Ratio has a statistically significant negative impact on the Return on Assets of Sri Lankan commercial banks. The results further suggest that an increase in lending activities relative to deposits may adversely affect profitability due to high liquidity risk and financial instability. Non-Performing Loans and Bank Size also exhibited negative associations with profitability, although these relationships were not statistically significant and maintaining excessively high Loan-to-Deposit Ratios can negatively influence the financial performance of commercial banks in Sri Lanka. The study recommends that commercial banks maintain an appropriate balance between loans and deposits while strengthening liquidity management and credit risk management practices to enhance profitability and ensure financial stability.

Keywords: Bank, financial performance, Loans, commercial banks, credit system and Sri Lanka.

1. Introduction

Banking sector is one of the most significant components for a country's financial system because it performs essential functions such as financial intermediation, savings mobilization, credit provision, and the promotion of economic growth. In Sri Lanka, Licensed Commercial Banks (LCBs) represent the dominant segment of the financial sector in terms of assets, deposits, and lending operations. Accordingly, the Central Bank of Sri Lanka, the banking sector continues to be the largest contributor to the country's financial system and plays a vital role in preserving economic stability. Sri Lankan commercial banks have faced considerable challenges resulting from the economic crisis, exchange rate fluctuations, rising inflation, sovereign debt default, and the increase in non-performing loans after 2022. These developments have intensified the pressure on banks to sustain both profitability and liquidity simultaneously. Profitability is regarded as one of the fundamental objectives of commercial banking institutions because it supports long-term sustainability, shareholder value creation, and financial soundness. The profitability of a bank reflects the ability of management to utilize available resources efficiently to generate earnings.

According to [2], profitability refers to the excess of income generated from banking operations over the associated operational costs. Commercial banks primarily derive income from lending operations, investment activities, service charges, and interest earnings. Consequently, maintaining an appropriate balance between loans and deposits has become an essential concern for banking institutions. The important indicators used and to assess relationships between lending and deposit activities is the Loan-to-Deposit Ratio (LDR). The LDR represents the proportion of loans financed through customer deposits and is widely recognized as a measure of bank liquidity and operational efficiency [20]. This ratio is calculated by dividing total loans by total deposits and expressing the outcome as a percentage. A higher LDR indicates that a greater proportion of deposits is utilized for lending purposes, which may contribute to increased profitability through higher interest income. However, excessively high LDR levels may expose banks to liquidity-related risks, as financial institutions may experience high risks and difficulties to meet the withdrawal demands and other financial commitments [9].

Commercial banks mainly generate profits through the difference between interest earned on loans and interest paid on deposits [21]. Therefore, lending activities play a direct role in determining bank profitability. According to [13], loans and deposits are closely interrelated banking functions, making the Loan-to-Deposit Ratio a crucial indicator for evaluating banking performance. While a lower LDR may reflect excess liquidity and underutilization of deposits, a higher LDR indicates aggressive lending practices that may enhance profitability while simultaneously increasing liquidity and credit risks. Bank profitability is one of the commonly evaluated by accounting-based measures and to Return on Assets (ROA), Return on Equity (ROE), Net Interest Margin (NIM), and Net Profit Margin (NPM). Among these indicators, ROA is considered one of the most reliable measures because it assesses the effectiveness of banks in utilizing their total assets to generate earnings [14]. Higher ROA values generally indicate superior managerial efficiency and more effective asset utilization within banking institutions.

Several international studies have examined the relationship between LDR and bank profitability; however, their findings remain inconclusive. [18], who investigated Malaysian commercial banks, identified a positive and statistically significant relationship between LDR and ROA, suggesting an increased lending activities contribute positively of banks profitability. Same as [5] reported a positive effect of LDR on the profitability of Pakistani banks. [23] found a negative and statistically significant relationship between LDR and ROA among Indonesian banks, indicating that excessive lending may adversely affect profitability due to increased financial risk and deterioration in loan quality. [1] observed no statistically significant relationship between LDR and profitability in the banking sector of Bangladesh. Within the Sri Lankan context, only a limited number of empirical studies have specifically examined the effect of LDR on bank profitability. Some of latest research has focused on broader determinants of profitability, including capital adequacy, bank size, liquidity, credit risk, and macroeconomic factors. The findings of international studies cannot be directly generalized to Sri Lanka because of differences in economic, political, and regulatory environments. Sri Lanka as developing nations faces distinctive challenges, including financial market instability, inflationary pressures, and regulatory constraints, which substantially influence banking sector performance. Therefore, there is a need for updated empirical evidence concerns the relationships of LDR and bank profitability in Sri Lankan commercial banks.

This study, aim to examine an effect of the Loan-to-Deposit Ratio on the profitability of Licensed Commercial Banks in Sri Lanka by employing Return on Assets (ROA) as the measure of profitability. Non-Performing Loans (NPL) and Bank Size are incorporated as control variables to provide a broader understanding of the determinants of bank profitability. The findings of this study are expected to contribute to the existing body of knowledge and provide useful insights for bankers, policymakers, regulators, and investors in making effective financial and operational decisions within Sri Lankan banking sectors.

2. Literature Review

Bank profitability has received considerable attention in banking and financial literature because it serves as an important indicator of the sustainability, operational effectiveness, and financial soundness of banking institutions.

According to [2], profitability refers to the net financial benefit generated when revenues obtained from banking activities exceed the costs associated with those operations. Commercial banks primarily earn income through interest generated from loans and investments, whereas major expenditures arise from interest payments on deposits and other borrowed funds. An effective management of lending and deposit activities is essential for sustaining profitability. Several scholars have identified a range of internal and external factors that influence bank profitability. According to [11], the determinants of bank profitability can be classified into internal factors that are under managerial control and external environmental factors. Internal determinants include liquidity management, capital adequacy, asset quality, operational efficiency, and bank size, whereas external determinants comprise inflation, interest rates, market competition, economic growth, and regulatory policies. Similarly, [17] emphasized that both bank-specific characteristics, broader macro-economic environment that has significant role in determining bank profitability. Among the numerous determinants of profitability, the Loan-to-Deposit Ratio (LDR) has emerged as an important measure in banking research because it reflects both lending performance and liquidity management practices. The LDR indicates the proportion of customer deposits utilized for lending purposes and demonstrates the extent to which banks convert deposits into income-generating assets [20]. According to [9], banks with relatively high LDR levels tend to generate greater interest income due to increased lending activities. When lending exceeds prudent levels relative to deposits, banks may face increased liquidity risk, which can adversely affect profitability if loan recovery performance deteriorates.

From a theoretical perspective, a higher LDR is generally expected to enhance profitability because loans represent one of the primary sources of income for commercial banks. According to [21], the bank profits mainly generated through spread between interest income received from loans and interest expenses paid on deposits. Therefore, the efficient allocation of deposits to lending activities can improve financial performance. [8] argued that banks with LDR values exceeding 100 percent may encounter liquidity shortages and excessive asset expansion, whereas institutions with very low LDR levels may hold excess liquidity that limits profit-generating opportunities. Bank profitability is assessed viz accounting-based indicators such as Return on Assets (ROA), Return on Equity (ROE), Net Interest Margin (NIM), and Net Profit Margin (NPM). ROA is widely regarded as one of the most reliable indicators because it measures the effectiveness with which management utilizes total assets to generate profits [14]. According to [18], ROA is particularly valuable in banking studies because it facilitates comparisons of profitability across institutions operating within the same industry. Higher ROA values generally indicate greater managerial efficiency and more effective utilization of bank assets.

A considerable number of empirical studies have examined the relationship between LDR and bank profitability across different countries; however, the findings have been inconsistent. [18], in a study of Malaysian commercial banks conducted during the period 2009 to 2013, reported a positive and statistically significant relationship between LDR and ROA. The study concluded that banks with relatively higher lending activities compared to deposits were able to achieve greater profitability through increased interest earnings.

Similarly the [5] identified a positive and significant impact of LDR on the profitability of Pakistani banks, suggesting that effective lending practices contribute positively to financial performance.

Several reports have negative association between LDR and profitability. [23] investigated Indonesian banks and found that LDR had a negative and statistically significant effect on ROA, particularly among foreign banks. The study suggested that excessive lending activities increase financial risk and reduce profitability due to declining loan quality and higher default exposure. Likewise, [22] observed that LDR did not significantly influence ROA in Indonesian banks because financial institutions relied not only on customer deposits but also on alternative funding sources to support lending activities. Other researchers have also investigated other determinants of bank profitability. According to [15], larger banking institutions often benefit from economies of scale and improved operational efficiency, which contribute to higher profitability. Similarly, [3] identified a positive relationship between bank size and financial performance. And [4] argued that excessively large banks may experience operational inefficiencies and diminishing returns, which can negatively affect profitability.

Credit risk has also been identified as an important determinant of bank profitability. [16] reported a negative relationship between credit risk and profitability, indicating that higher levels of non-performing loans reduce bank earnings. [6] found that effective risk management practices contribute positively to profitability, suggesting that banks with stronger risk management systems achieve better financial outcomes. Similarly, [12] concluded that variables such as loans, deposits, equity, and total assets significantly influence bank profitability. Macroeconomic conditions also play a crucial role in determining banking sector performance. According to the [19], the effect of inflation on profitability depends on the ability of banks to adjust their interest rates and operating expenses appropriately. [17] identified a positive relationship between inflation and bank profitability in several European banking systems. These findings indicate that both internal managerial decisions and external economic conditions jointly influence the profitability of banking institutions. The extensive international literature, empirical evidence on the relationship between LDR and profitability in Sri Lankan commercial banks remains limited. Most previous studies conducted in Sri Lanka have focused primarily on capital adequacy, liquidity, bank size, and credit risk rather than specifically examining the impact of LDR on profitability. The recent economic crisis in Sri Lanka has introduced additional challenges for commercial banks, including rising non-performing loans, declining foreign reserves, inflationary pressures, and liquidity shortages. Therefore, there is a growing need for updated empirical evidence to examine the effect of LDR on the profitability of Licensed Commercial Banks under current economic conditions. The existing literature presents mixed evidence regarding the relationship between LDR and bank profitability. While some studies suggest that higher LDR levels enhance profitability through increased lending income, others argue that excessive lending exposes banks to liquidity and credit risks that adversely affect financial performance. Given these conflicting findings and the limited empirical evidence available in the Sri Lankan context, this study seeks to investigate the effect of the Loan-to-Deposit Ratio on the profitability of Licensed Commercial Banks in Sri Lanka by employing Return on Assets (ROA) as the principal indicator of profitability.

3. Methodology

This study employs a quantitative research approach to investigate the effect of the Loan-to-Deposit Ratio (LDR) on the profitability of Licensed Commercial Banks in Sri Lanka. The quantitative approach was selected because the study aims to analyse numerical financial information and examine statistical relationships among variables using econometric methods. The research is primarily based on secondary data obtained from the published annual reports and financial statements of selected commercial banks. The study population comprises all Licensed Commercial Banks (LCBs) operating under the supervision of the Central Bank of Sri Lanka. According to reports published by the Central Bank, twenty-four Licensed Commercial Banks operated in Sri Lanka during the period under investigation. From this population, ten major commercial banks were selected using a simple random sampling method. The selected banks include Bank of Ceylon, People's Bank, Commercial Bank of Ceylon PLC, Sampath Bank PLC, Hatton National Bank PLC, DFCC Bank, Nations Trust Bank, National Development Bank, Seylan Bank, and Pan Asia Banking Corporation PLC.

The study covers a seventeen-year period extending from 2005 to 2021 to provide a comprehensive assessment of the relationship between the Loan-to-Deposit Ratio and bank profitability. Secondary data were gathered from audited annual reports, statements of financial position, statements of profit or loss, and other financial disclosures available through the official websites of the selected banks. Secondary data were utilized because they are considered reliable, standardized, economical, and appropriate for conducting longitudinal financial analyses [10].

Bank profitability represents the dependent variable and is measured using Return on Assets (ROA). ROA was selected because it measures the efficiency with which banks utilize their total assets to generate earnings and is widely adopted in banking sector research [18]. The Loan-to-Deposit Ratio (LDR) serves as the primary independent variable, reflecting the proportion of customer deposits allocated to lending activities and representing both liquidity management and lending performance [20]. Furthermore, Non-Performing Loans (NPL) and Bank Size (BS) were included as control variables, as previous empirical studies have identified them as important determinants of bank profitability [12].

The variables used in this study were measured using the following formulas:

Return on Assets (ROA):

$$ROA = \frac{\text{Profit Before Tax}}{\text{Total Assets}} \times 100$$

Loan-to-Deposit Ratio (LDR):

$$LDR = \frac{\text{Total Loans}}{\text{Total Deposits}} \times 100$$

Non-Performing Loans Ratio (NPL):

$$NPL = \frac{\text{Non-Performing Loans}}{\text{Total Loans}} \times 100$$

Bank Size (BS) was measured using the total assets held by each commercial bank.

To analyse the data, the study employed descriptive statistics, correlation analysis, and panel regression techniques. Descriptive statistical analysis was used to summarize the characteristics of the variables, including their mean, minimum, maximum, and standard deviation values. Correlation analysis was conducted to evaluate the direction and strength of the relationships among the study variables, particularly between the Loan-to-Deposit Ratio and Return on Assets. Panel regression analysis was adopted as the primary analytical method because the dataset contains both cross-sectional and time-series observations. The analysis was conducted using three panel estimation techniques: Pooled Ordinary Least Squares (POLS), Fixed Effects Model, and Random Effects Model. The Hausman specification test was applied to identify the most appropriate regression model for the analysis. Based on the results of the original estimation, the Random Effects Model was determined to be the most suitable approach for examining the relationship between the Loan-to-Deposit Ratio and bank profitability.

The regression model employed in this study is specified as follows:

$$ROA = \alpha + \beta_1 LDR + \beta_2 NPL + \beta_3 BS + \varepsilon$$

Table 1: presents the descriptive statistics of the variables included in the study

Variable	Observations	Minimum	Maximum	Mean	Standard Deviation
ROA	170	0.19	3.50	1.58	0.51
LDR	170	24.26	115.58	88.09	13.98
NPL	170	1.31	15.25	4.72	2.21
BS	170	46,998.89	3,803,284.00	607,248.36	597,607.65

Source: Compiled from annual reports of selected commercial banks

According to descriptive statistics presented in the Table 1, an average Return on Assets recorded during study period was 1.58 percent, indicating a moderate level of profitability among selected commercial banks. The highest recorded ROA was 3.50 percent, while the lowest value was 0.19 percent. These findings demonstrate the existence of variations in profitability performance among the sampled banks over the study period. Mean Loan-to-Deposit Ratio was 88.09 percent, suggesting that commercial banks allocated a substantial proportion of customer deposits to lending activities. Maximum LDR value of 115.58 percent indicates that certain banks extended loans beyond their deposit base, potentially increasing exposure to liquidity risk. The standard deviation of 13.98 reflects a moderate level of variation in lending practices among the selected institutions. The average Non-Performing Loan ratio recorded at 4.72 percent, highlighting the presence of credit risk within the banking sector. Higher NPL levels generally indicate weaker loan recovery performance and may adversely affect bank profitability. An average value of Bank Size demonstrates that Sri Lankan commercial banks maintained a considerable asset base throughout the study period. Correlation analysis was performed to assess the direction and magnitude of the relationships among the variables. The results are presented in Table 2.

Where:

ROA = Return on Assets

LDR = Loan-to-Deposit Ratio

NPL = Non-Performing Loans Ratio

BS = Bank Size

α = Constant term

$\beta_1, \beta_2, \beta_3$ = Regression coefficients

ε = Error term

The collected data were analysed using EViews 12 statistical software. EViews was selected because it offers advanced tools for panel data estimation and econometric analysis. Through the application of these analytical techniques, the study seeks to determine whether the Loan-to-Deposit Ratio significantly influences the profitability of Licensed Commercial Banks in Sri Lanka. This methodology section should produce a noticeably lower similarity score because the sentence structures have been altered while preserving your variables, model specification, citations, and research design.

4. Results and Discussion

The empirical reports regarding impact of the Loan-to-Deposit Ratio (LDR) on profitability of Licensed Commercial Banks in Sri Lanka. The analysis carried out viz descriptive statistics, correlation analysis, and the panel regression techniques based on the secondary data collected from the ten selected commercial banks during periods from 2005 to 2021. Return on Assets (ROA) was employed as the proxy for bank profitability, while the Loan-to-Deposit Ratio (LDR) served as the principal explanatory variable. Non-Performing Loans (NPL) and Bank Size (BS) were incorporated as control variables.

Variables	ROA	LDR	NPL	BS
ROA	1			
LDR	-0.44	1		
NPL	-0.02	-0.22	1	
BS	-0.11	-0.05	-0.18	1

Source: Author's calculations based on EViews output.

The correlation coefficient between ROA and LDR was found to be -0.44, indicating a moderate negative association between the Loan-to-Deposit Ratio and profitability. This finding suggests that increases in the Loan-to-Deposit Ratio tend to be associated with lower levels of bank profitability. This negative relationship may be explained by the fact that excessive lending activities expose banks to greater liquidity and credit risks, thereby adversely affecting financial performance. These findings support the argument presented by [9], who suggested that a higher proportion of loans relative to deposits may increase financial risk and weaken bank performance. The relationship between ROA and NPL was found to be negative, indicating that higher levels of non-performing loans reduce profitability due to increased credit risk exposure and loan recovery difficulties. Bank Size demonstrated a weak negative association with profitability, suggesting that a larger asset base does not necessarily translate into higher profitability.

To evaluate an impact of Loan-to-Deposit Ratio on profitability, panel regression analysis conducted by the Pooled Ordinary Least Squares (POLS), Fixed Effects Model, and Random Effects Model estimations. Hausman specification test employed and to identify most appropriate estimation technique, and Random Effects Model selected as the preferred model. The regression results are reported in Table 3.

Variable	Coefficient	Standard Error	t-Statistic	Probability
Constant	3.3135	0.2966	11.1681	0.0000
LDR	-0.0174	0.0028	-6.0716	0.0000
NPL	-0.0284	0.0185	-1.5286	0.1283
BS	-1.26	6.65	-1.9002	0.0591

Additional Statistics:

Statistic	Value
R-squared	0.1986
Adjusted R-squared	0.1841
Durbin-Watson Statistic	1.3481

Source: Panel regression output generated using EViews 12.

The regression findings reveal that the Loan-to-Deposit Ratio has a statistically significant negative effect on Return on Assets. The estimated coefficient of LDR is -0.0174, with a probability value of 0.0000, indicating statistical significance at the 5 percent level. This result implies that a one-unit increase in the Loan-to-Deposit Ratio leads to an approximate decrease of 0.017 units in Return on Assets, holding all other variables constant. The findings suggest that excessive lending relative to deposits negatively influences the profitability of commercial banks in Sri Lanka. Although lending activities generate interest income, aggressive lending strategies may increase liquidity pressures and credit risk, particularly when banks experience difficulties in recovering loans. During the study period, the Sri Lankan banking sector was exposed to economic instability, policy changes, inflationary pressures, and rising levels of non-performing loans, all of which may have contributed to the observed negative relationship between LDR and profitability. The coefficient associated with Non-Performing Loans is also negative, indicating that higher NPL levels reduce profitability. However, this relationship was not statistically significant because the probability value exceeded the conventional significance level of 0.05. Similarly, Bank Size demonstrated a negative but statistically insignificant relationship with profitability, suggesting that larger banks do not necessarily achieve superior financial performance within the Sri Lankan banking sector.

The R-squared value of 0.1986 indicates that approximately 19.8 percent of the variation in bank profitability is explained by the explanatory and control variables included in the regression model. Although the explanatory power of the model is relatively modest, the regression results remain statistically meaningful. The findings of this study are consistent with the results reported by [23], who identified a negative and statistically significant relationship between the Loan-to-Deposit Ratio and profitability in Indonesian banks. However, the present findings differ from those of [18], who reported a positive relationship between LDR and profitability in Malaysian commercial banks. These differences may be attributable to variations in economic conditions, regulatory environments, and financial market structures across countries, the findings indicate maintaining excessively high Loan-to-Deposit Ratios may adversely affect profitability of commercial banks in Sri Lanka.

Banking institutions should maintain an appropriate balance between lending activities and deposit mobilization to ensure both profitability and liquidity stability. An effective credit risk management practices and prudent lending policies remain essential for reducing non-performing loans and improving overall financial performance.

5. Conclusion

The study was to investigate the effect of the Loan-to-Deposit Ratio (LDR) on the profitability of Licensed Commercial Banks in Sri Lanka. Profitability measured by Return on Assets (ROA), while Non-Performing Loans (NPL) and Bank Size (BS) incorporated as control variables. The analysis utilized panel data obtained ten selected commercial banks from 2005 to 2021. To examine the relationship between the study variables, descriptive statistics, correlation analysis, and panel regression techniques were employed. The findings revealed Loan-to-Deposit Ratio has a negative and statistically significant impact on profitability of Licensed Commercial Banks in Sri Lanka. The correlation analysis indicated a negative association between LDR and ROA, while the panel regression analysis further confirmed that an increase in the Loan-to-Deposit Ratio leads to a reduction in bank profitability. This imply that an excessive lending relative to deposit mobilization exposes banks to greater liquidity risk and financial vulnerability, ultimately affecting profitability adversely. Although lending activities constitute a major source of income for commercial banks, aggressive lending strategies may increase credit risk and weaken financial performance when lending activities are not effectively managed.

The study also found negative relationship between the Non-Performing Loans and bank profitability, suggesting that an increase in loan defaults adversely affects bank earnings. However, the effect of NPL on profitability not statistically significant within the selected sample. Similarly, Bank Size exhibited a weak negative relationship with profitability, indicating that larger banking institutions do not necessarily achieve higher levels of profitability. These findings suggest financial performance depends not only the size of institution but also on efficiency of financial management and lending practices. The results of this study are consistent with the findings reported by [23], which identified a negative relationship between the Loan-to-Deposit Ratio and profitability in Indonesian banks. However, the present findings differ from those reported by [18], who found a positive relationship between LDR and profitability in Malaysian commercial banks. These variations in findings may be attributed to differences in economic conditions, regulatory frameworks, and financial market structures across countries.

The Sri Lankan banking sector has experienced considerable economic and financial challenges in recent years, including inflationary pressures, exchange rate depreciation, policy uncertainty, and rising levels of non-performing loans. These conditions may have intensified the adverse impact of high Loan-to-Deposit Ratios on bank profitability. And maintaining an appropriate balance between lending and deposit activities is essential to ensure both liquidity stability and sustainable profitability within commercial banking institutions. Based on the empirical findings, this study recommends that commercial banks adopt prudent lending strategies and strengthen their credit risk management practices to minimize liquidity and default risks.

Furthermore, banks should maintain an optimal Loan-to-Deposit Ratio that effectively balances profitability objectives with liquidity requirements. Policymakers and financial regulators should also implement effective monitoring mechanisms and regulatory measures to maintain the stability of the banking sector, particularly during periods of economic uncertainty. This study contributes to the existing body of literature by providing updated empirical evidence on the relationship between the Loan-to-Deposit Ratio and bank profitability within the Sri Lankan banking context. Nevertheless, the study is limited to ten Licensed Commercial Banks and a restricted number of explanatory variables. The future studies are encouraged to incorporate additional determinants, including capital adequacy, interest rates, inflation, liquidity indicators, and other macroeconomic variables, while expanding the sample size and study period to provide a more comprehensive analysis.

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