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**BANKING SECTOR COMPETITIVENESS AND PRACTICES IN SRI LANKA****Kariyapperu Mudiyansele Dharmasiri Bandara Rekogama****ABSTRACT**

*The competitiveness of the banking sector is a critical dimension of financial sector development, influencing efficiency, stability, and the ability of banks to support broader economic growth. This paper examines the competitive landscape of the Sri Lankan banking industry, evaluates competitive practices among commercial banks, and explores how competition impacts service delivery, efficiency, and financial stability. Drawing on empirical evidence from studies using the Panzar-Rosse model and other competitive measures, the paper finds that Sri Lanka's banking sector exhibits moderate competition, driven by non-price competitive strategies and evolving market dynamics post liberalization. Policy and structural adjustments are discussed to enhance competitive outcomes and support a resilient banking environment.*

**INTRODUCTION**

The banking sector plays a pivotal role in the economic and financial architecture of Sri Lanka, serving as the primary intermediary between savings and investment and facilitating economic activity across all sectors. As the dominant component of the country's financial system, the banking sector accounts for a substantial share of financial assets, credit allocation, payment services, and risk management functions. The efficiency, stability, and competitiveness of banks therefore have far-reaching implications for macroeconomic stability, private sector development, and long-term economic growth.

Banking sector competitiveness refers to the degree to which banks operate in an environment that encourages efficiency, innovation, fair pricing, and improved service quality. In competitive banking systems, institutions are incentivized to reduce costs, diversify products, enhance customer service, and adopt technological innovations. At the same time, excessive competition may pose risks to financial stability by encouraging aggressive risk-taking. Consequently, understanding the nature and extent of competition within the banking sector is crucial for policymakers and regulators seeking to balance efficiency with systemic stability.

Sri Lanka's banking sector has undergone significant structural and institutional transformation since the introduction of financial liberalization policies in the late 1970s. These reforms aimed to modernize the financial system, enhance market efficiency, and increase competition by reducing entry barriers, deregulating interest rates, and encouraging private and foreign bank participation. As a result, the sector evolved from a state-dominated system to a more diversified market structure comprising state-owned banks, private domestic banks, and foreign banks operating under a common regulatory framework.

Despite these reforms, the degree of competition in Sri Lanka's banking sector remains a subject of ongoing debate. While increased market participation and product diversification suggest a more competitive environment, structural characteristics such as market concentration, regulatory constraints, and dominance of a few large banks may limit the intensity of competition. Moreover, competition in the banking sector is not confined to interest rate behavior alone; it increasingly manifests through non-price dimensions such as digital banking services, customer relationship management, product innovation, branch network expansion, and fee-based services.

Banking practices in Sri Lanka have also evolved in response to technological advancements, changing customer expectations, and regulatory developments. The rapid adoption of digital banking platforms, mobile payment systems, and electronic financial services has reshaped competitive dynamics, compelling banks to differentiate themselves through service quality and technological efficiency. Additionally, banks have increasingly relied on off-balance sheet activities and non-interest income sources to enhance profitability and competitive positioning, reflecting broader global banking trends.

The relationship between competition and banking practices is particularly significant in the Sri Lankan context, where the sector must simultaneously support economic development, ensure financial inclusion, and maintain systemic resilience amid macroeconomic volatility. Moderate levels of competition may foster stability, but insufficient competition can lead to inefficiencies, limited innovation, and higher costs for consumers. Conversely, unrestrained competition may erode profit margins and incentivize excessive risk-taking, potentially undermining financial stability.

Although several empirical studies have examined banking sector competition in Sri Lanka—often using models such as the Panzar-Rosse H- statistic—there remains a need for a comprehensive assessment that integrates competitive intensity with prevailing banking practices. Existing research tends to focus on quantitative measures of competition without sufficiently analyzing how operational strategies, service delivery models, and regulatory frameworks shape competitive outcomes. Moreover, the impact of competition on service quality, efficiency, and long-term sustainability requires further exploration, particularly in a developing economy context.

Against this backdrop, this study examines the competitiveness of Sri Lanka's banking sector and analyzes the practices adopted by banks to enhance their competitive position. By synthesizing empirical evidence and institutional insights, the study aims to provide a nuanced understanding of how competition operates within the Sri Lankan banking system and how banking practices influence market performance. The findings are expected to contribute to the literature on banking competition in emerging economies and offer policy-relevant insights for regulators, financial institutions, and stakeholders seeking to strengthen the efficiency and resilience of Sri Lanka's banking sector.

## LITERATURE REVIEW

### Competitive Dynamics in Sri Lanka's Banking Sector

Financial liberalization policies introduced in the late 1970s and subsequent banking reforms have substantially transformed Sri Lanka's banking market structure. These reforms were aimed at enhancing productivity, efficiency, and competitiveness through deregulation, expansion of market entry, and increased reliance on market forces—thereby moving away from previously repressed financial structures. Research reveals that competition among commercial banks in Sri Lanka has intensified over time, as evidenced by shifts in market shares of deposits, loans, and overall assets across both state and private banks. These developments signal an increased role of competitive forces shaping financial sector behavior.

### Empirical Measurement: Panzar-Rosse Model

Empirical studies have applied the Panzar-Rosse (PR) H-statistic to measure the degree of competitiveness in Sri Lanka's commercial banking sector. A study covering the period 1996–2018 found that the Sri Lankan banking sector is moderately competitive, suggesting that while banks engage in competitive activities, competition is not strong enough to characterize the market as fully contestable. Moreover, differences in competitive behavior across bank ownership types (state, private, and foreign banks) were minimal, though foreign banks displayed relatively lower competitiveness compared to local banks in certain measures.

Research also emphasizes that competition in Sri Lanka often manifests through non-price dimensions—such as customer relationship strategies, marketing, and product bundling—rather than through interest rates alone. This may reflect the influence of regulatory frameworks and macroeconomic policies on pricing behavior within the sector.

### Off-Balance Sheet Activities and Competitive Strategy

Beyond core banking activities, competition extends to off-balance sheet (OBS) services, including guarantees, trade financing and fee-based financial services. Empirical evidence indicates that the degree of competition for off-balance sheet activities is lower than for traditional core banking services in Sri Lanka; however, these OBS activities positively contribute to overall banking competitiveness when integrated effectively into bank business models. This suggests that banks with diversified revenue streams may achieve competitive advantage and enhance market position.

### Competition and Financial Stability

Competition can influence financial stability, with mixed empirical findings globally. In the Sri Lankan context, moderate competition has been associated with stability concerns in some studies, indicating a complex relationship where too much competition can pressure banks to take undue risk, while too little competition may reduce efficiency and innovation. A nuanced balance is therefore crucial for sustainable sector development.

### Research Objectives

- To assess the level of competitiveness in the Sri Lankan banking sector.
- To examine key banking practices influencing competitive behavior.
- To analyze differences in competitiveness among state, private, and foreign banks.

- To evaluate the impact of competition on service quality and efficiency in banks

### Methodology

This research employs a mixed-method approach comprising a critical review of secondary data from peer-reviewed journals, industry reports, and empirical studies on the Sri Lankan banking sector. Emphasis is placed on studies that use quantitative competitiveness measures (e.g., PR H- statistic) and qualitative evaluations of banking practices. Comparative analysis is used to evaluate competitive dynamics across bank categories (state vs. private vs. foreign) and to assess operational strategies used to enhance competitive performance.

### FINDINGS

#### Degree of Competition

Analysis of bank-level panel data reveals that Sri Lanka's banking sector exhibits *moderate competitive intensity*. The Panzar-Rosse H-statistic estimates consistently fall below levels that indicate strong competition but above levels signalling monopoly or inefficient competition. This suggests that while market forces have increased competition since liberalization, structural and regulatory constraints limit its full expression.

#### Ownership and Competitive Behavior

State-owned, private domestic, and foreign banks show similar competitive dynamics, though foreign banks generally display lower competitive responsiveness in domestic market activities. These differences may be attributed to distinct strategic priorities, customer bases, and operational constraints faced by foreign banks operating within Sri Lanka's regulatory environment.

#### Non-Price Competition

Non-price competition—including customer service strategies, technological adoption, and product diversification—is a significant driver of competitive outcomes. Banks increasingly focus on digital banking platforms, relationship management services, and tailored financial products to attract and retain customers, indicating a broader competitive landscape beyond interest rate competition.

#### Strategic Innovation and Efficiency Practices

Modernization practices, such as adopting advanced operating models and digital technologies, play a role in enhancing bank competitiveness. Case studies of retail banking in Sri Lanka highlight how modernization responds to changing customer behavior and competitive pressures shape strategic decisions.

### DISCUSSION

The moderate level of competition in Sri Lanka's banking sector suggests a balanced environment, where banks compete on multiple fronts without extreme competitive pressures that could undermine financial stability. Non-price competition has emerged as a key strategic dimension, aligning with global trends where digital innovation, customer experience, and fee-based services complement traditional interest rate competition.

However, competitive intensity is influenced by regulatory policies, macroeconomic conditions, and bank concentration patterns. Policies aimed at enhancing transparency, easing market entry, and promoting financial infrastructure improvements can further stimulate competitive dynamics while safeguarding financial stability.

### CONCLUSION AND POLICY IMPLICATIONS

Sri Lanka's banking sector is characterized by moderate competition, with competition extending beyond price to include digital services, product diversification, and strategic innovation. Foreign banks appear less competitive in domestic core activities, while local and private banks demonstrate adaptive strategies within the market. Strengthening market competition requires calibrated policy interventions that support innovation, enhance regulatory transparency, and foster technological adoption across all bank categories.

#### Key policy recommendations include:

- Encouraging further non-price competitive practices through innovation incentives.
- Enhancing financial market infrastructure to reduce frictions in pricing and service delivery.
- Supporting capacity building for banks to expand digital and off-balance sheet services.

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Future research could explore longitudinal impacts of competition on long- term financial stability and economic growth.

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