THE UNSEEN HAND AND THE BALANCE SHEET: TRACING THE SHADOW OF CORRUPTION AND MONEY LAUNDERING ON SRI LANKAN BANK STABILITY AND PROFITABILITY

Ishara Nuwan Wickramarathne [(a)] Himal Muthunayake [(b)] Isuru Sandakelum [(c)I]

[(a)]Data Analyst, Department of Accountancy, Faculty of Commerce and Management Studies, University of Kelaniya, Sri Lanka; E-mail: inbwickramarathna7@gmail.com
[(b)]Lecturer, Department of Accountancy, Faculty of Commerce and Management Studies, University of Kelaniya, Sri Lanka; E-mail: himalm@kln.ac.lk
[(c)]Assistant Lecturer, Department of Accountancy, Faculty of Commerce and Management Studies, University of Kelaniya, Sri Lanka; E-mail: eaisa231@kln.ac.lk

ARTICLE INFO

ABSTRACT

The resilience of the financial system depends on the stability and profitability of the banking industry, particularly in developing countries, where financial crimes and poor governance persist as ongoing problems. Concern about money laundering and corruption has grown in Sri Lanka, particularly during periods of stress in the banking industry. However, empirical data on how these illicit activities affect bank-level performance remains limited. This Study examines the stability and profitability of regulated commercial banks in relation to corruption and money laundering. Panel data from 24 licensed commercial banks from 2016 to 2024 are used. To identify institution-specific impacts over time, fixed effects regression models are used to analyse bank profitability and stability metrics, while accounting for bank size and management effectiveness. The empirical findings indicate corruption has a statistically significant negative impact on stability and profitability, and coefficient estimates show that bank performance consistently declines as corruption increases. Money laundering, on the other hand, shows a mixed relationship, with some model specifications indicating a positive, statistically significant association with stability and profitability. While managerial effectiveness is positively correlated with bank stability, bank size hurts profitability but makes a favourable, considerable contribution to stability. The Study's quantitative results show that while the effects of money laundering are context-dependent and vary across performance characteristics, corruption consistently impairs banks' financial performance and stability. Overall, the results confirm the asymmetric influence of economic crimes, including money laundering and corruption, on Sri Lankan bank stability and economic performance.

INTRODUCTION

The banking sector serves as the fundamental circulatory system of a nation's economy, particularly in developing island nations like Sri Lanka. Licensed Commercial Banks (LCBs) are the primary repositories of public trust and the engines of credit creation that fuel infrastructure, small and medium enterprises, and international trade (Bhargava & Minoli, 2015; Chakraborty, 2024). In the contemporary financial landscape, the stability of these institutions is no longer solely threatened by traditional market risks such as interest rate volatility or credit defaults. Instead, a more insidious "unseen hand" is at play, the influence of financial crimes, specifically corruption and money laundering. As Sri Lanka navigates a complex recovery from its most severe economic crisis in decades, the integrity of its balance sheets has become a matter of national survival. The resilience of the banking sector is inextricably linked to the strength of its institutional safeguards against the infiltration of illicit capital and the erosion of governance through corrupt practices.

This research lies in the urgent need to protect the Sri Lankan financial system from systemic collapse. In the post-2020 era, the global financial community placed increased scrutiny on jurisdictions with perceived "grey" regulatory areas (Smith, 2023). For Sri Lanka, which has historically struggled with maintaining consistent standards in the eyes of the Financial Action Task Force, the economic consequences of being labelled a high-risk jurisdiction are catastrophic (Shah & Aish, 2022). Recent global events, including the tightening of international liquidity and the rise of digital financial forensics, have made it impossible for banks to ignore the "shadow" cast by illicit flows. The relevance of this topic is further

underscored by the increasing sophistication of money laundering techniques, which now utilise complex layering through shell companies and digital assets, often facilitated by corrupt gatekeepers within the political and financial spheres (Malik, 2025).

The heart of this research is the lack of empirical quantification of how shadow economic activities, such as corruption and money laundering, distort the profitability (performance) and stability of formal banking institutions in a developing economy. While theoretical frameworks suggest that corruption leads to inefficient asset allocation and money laundering creates artificial liquidity (Becker, 1968; Jensen & Meckling, 1976), there is a profound lack of evidence-based research documenting these specific statistical relationships within the Sri Lankan context. Traditional banking performance models are often "clean-room" simulations that assume a transparent operational environment. However, in reality, the "unseen hand" of financial crime operates as a hidden variable that alters banks' risk-return profiles (Nasreen et al., 2024). The problem is that without understanding the magnitude of this impact, regulators cannot design effective anti-money laundering (AML) or anti-corruption frameworks tailored to the nuances of the local market (Bhargava & Minoli, 2015). There is a critical gap between the legal definitions of financial crime and their actual, measurable impact on profitability and the stability of commercial banks (Rehman et al., 2024).

This Study is heightened by the recent economic shifts between 2020 and 2025. During this period, the Sri Lankan banking sector faced unprecedented pressure from sovereign debt restructuring and hyperinflation. In such volatile environments, the temptation for "regulatory capture" and the influx of "dark money" increases (Shah & Aish, 2022). Emerging markets, corruption serves as a barrier to effective legislation, deterring foreign direct investment and directly deteriorating the quality of bank assets. Furthermore, Rehman et al. (2024) argue that the nexus between political instability and financial crime creates a "toxicity" that disproportionately affects bank stability. This research addresses the scientific problem by testing whether these global trends hold for Sri Lanka's 24 licensed commercial banks, providing the first comprehensive longitudinal analysis of this nature in the region (Nasreen et al., 2024). To investigate this problem, the Study employs a quantitative approach, utilising panel data from 2016 to 2024, to analyse the impact of money laundering and corruption on the profitability and stability of Sri Lanka's licensed commercial banks.

The paper is organised into five major chapters. Chapter two provides a comprehensive literature review and theoretical framework that lead to the formulation of research hypotheses. Chapter three details the materials and methods used for data collection and analysis. Chapter four presents the numerical results and statistical findings. Finally, Chapter Five discusses the implications of the results, contextualises them within the current literature, and provides a summary of the findings.

LITERATURE REVIEW

Commercial banks serve as the backbone of the economy, coordinating investment lending, consumer transactions, corporate financing, and deposit mobilisation. Particularly in developing nations like Sri Lanka, these diverse roles support economic stability and industrial growth. Banks play an essential role in the economy, as demonstrated. However, the efficacy and stability of banks are increasingly threatened by the growing twin challenges of corruption and money laundering, two interrelated illicit phenomena that compromise institutional integrity, distort financial markets, and then pose systemic threats.

Theoretical Frameworks of Corruption and Money Laundering

The theoretical foundation of this Study is built upon the synthesis of three primary schools of thought: Agency Theory, Institutional Theory, and the Economic Theory of Crime. Together, these frameworks provide a lens through which we can understand how illicit activities bypass formal controls to impact the balance sheet. Agency Theory, as popularised by Jensen and Meckling (1976), posits that the separation of ownership and control in banks creates a vacuum in which managers may act in their own self-interest rather than in shareholders' interests. In the context of corruption, this manifests as "crony capitalism," where bank officials may approve high-risk loans to politically connected individuals in exchange for private benefits or favours. This leads to an accumulation of non-performing loans (NPLs), which directly erodes profitability and stability. Institutional theory, as proposed by DiMaggio and Powell (1983), suggests that banks often adopt AML measures not because they are inherently effective, but instead to gain legitimacy in the eyes of international regulators. This "isomorphic" behaviour can lead to a "checkbox" compliance culture that misses actual criminal activity, thus leaving the bank's stability vulnerable despite high compliance costs. This theory illustrates how regulatory pressures shape, or undermine, banks' internal controls and their ability to counter illegal financial flows. Stricter capital and risk governance regulations have compelled banks to strengthen their compliance infrastructure, thereby reducing financial and reputational risks associated with corruption and money laundering (Basel Committee on Banking Supervision, 2010).

The Economic Theory of Crime, pioneered by Becker (1968), suggests that individuals engage in money laundering and corruption when the expected utility of the crime exceeds the risk of detection and punishment. In developing nations where the rule of law is perceived as weak, the "cost" of financial crime is low, leading to higher rates of illicit activity. This theory is central to understanding why money laundering might appear to provide a short-term boost to bank liquidity; if the risk of detection is low, banks may inadvertently (or willfully) benefit from the influx of "dark money" to meet capital adequacy requirements, even though this compromises their long-term solvency. These artificially inflate asset prices, distort market mechanics, create unfair competition, and threaten the integrity of the financial system (Malik, 2025). It highlights the sophisticated layering strategies employed by these criminals, including cross-border transactions and the use of shell corporations, which make detection and enforcement more challenging.

Empirical Evidence on Corruption and Money Laundering Impact

The analysis of global literature reveals a consistent negative correlation between corruption and bank health. Nasreen et al. (2024) analysed bank stability across 15 Asian countries. They found that corruption acts as a "sand in the wheels" of financial efficiency, increasing the cost of doing business and reducing overall stability. Similarly, Rehman et al. (2024) conducted a global study spanning 50 emerging markets and concluded that corruption significantly increases the likelihood of bank failure by encouraging reckless risk-taking. In the Middle Eastern context, banks invest heavily in AML measures, yet corruption persists, undermining these efforts and creating a volatile banking environment.

In Africa, recent studies have shown that corruption hinders the effectiveness of monetary policy. Smith (2023) argued that when banks serve as conduits for corrupt payments, they lose their ability to act as neutral intermediaries, thereby distorting markets. In Pakistan, the infiltration of money laundering proceeds into the banking system led to a temporary inflation of asset prices, followed by a sharp correction that threatened systemic stability. This "boom-bust" cycle, driven by illicit flows, is a recurring theme in the literature from high-risk jurisdictions. The European experience offers a different perspective, focusing on the "compliance burden." Shah and Aish (2022) found that for European banks, the cost of AML compliance has risen to the point where it significantly impacts ROA, yet the actual detection rates of money laundering remain low. This suggests a diminishing return on investment in compliance. However, recent research in North America emphasises the role of "reputational risk," showing that banks involved in money laundering scandals face long-term declines in shareholder value that far exceed the actual regulatory fines imposed.

Regional studies in South Asia have begun to highlight the "context-specific" nature of these crimes. In Sri Lanka, the "informal economy" is so large that it inevitably leaks into the formal banking sector, creating unique challenges for AML officers. The lack of whistleblower protection in Sri Lanka makes it difficult to detect internal corruption within LCBs. These local factors suggest that global models must be adjusted to account for the island's specific socio-political landscape. Further exploring the mechanics of money laundering, Malik (2025) discusses the role of "layering" in the modern era, where digital assets are used to obscure the audit trail. This technological shift has left many traditional LCBs in developing nations struggling to keep up, increasing their operational risk. Chakraborty (2024) found that bank size is a significant moderator; larger banks are better equipped to absorb the costs of compliance but are also more attractive targets for sophisticated money launderers. In contrast, smaller banks may have tighter internal controls but lack the technological resources to detect complex "layering" schemes.

The relationship between corruption and stability is further explored, which found that in the Sri Lankan context, corruption is often masked as "operational inefficiency." This makes it difficult for regulators to distinguish between a bank that is poorly managed and one that is being looted from within. Islamic banking in the region, and found that ethical banking frameworks might offer greater resistance to corruption. However, they are not immune to the broader economy's systemic pressures. Refining the focus on profitability, Masciandaro et al. (2007) argue that money laundering distorts the competitive landscape. Banks that accept "dark money" can offer lower interest rates to attract legitimate customers, thus driving honest banks out of the market or forcing them to lower their standards. This "race to the bottom" eventually undermines the entire sector. The cumulative effect of these distortions is a "brain drain" of talented financial professionals who refuse to work in a corrupt environment, further damaging long-term bank performance.

In conclusion, the literature suggests a complex, multifaceted relationship between financial crime and banking. While corruption is universally seen as a "drain" on resources, the impact of money laundering can be deceptively positive in the short term but toxic in the long term. There is a clear need for empirical research that employs robust statistical methods to disentangle these effects, especially in a jurisdiction like Sri Lanka, which is currently rebuilding its financial reputation. The following hypotheses have been formulated for testing based on the findings from the above literature.

> H_1: There is a significant Impact of Corruption on the Bank profitability of Licensed Commercial Banks in Sri Lanka.
> H_2: There is a significant Impact of Corruption on the Bank Stability of Licensed Commercial Banks in Sri Lanka.
> H_3: There is a significant Impact of Money Laundering on the Bank Profitability of Licensed Commercial Banks in Sri Lanka.
> H_4: There is a significant Impact of Money Laundering on the Bank Stability of Licensed Commercial Banks in Sri Lanka.

Challenges in AML Compliance and Reporting in the Sri Lankan Context

There are still many obstacles to overcome in Sri Lanka's AML compliance, both operationally and systemically. This is partially driven by the "crying wolf" situation, in which these banks' inappropriate or inaccurate reporting of suspicious activity can overwhelm regulatory bodies and obscure actual dangers in a deluge of less valuable data. Banks face penalties for failing to report suspicious transactions, which encourages them to report more, depleting resources and reducing the effectiveness of regulation (Smith, 2023). To optimise detection and enforcement mechanisms, this paradox underscores the urgent need for more specialised compliance frameworks and greater collaboration among banks, regulators, and law enforcement agencies (Central Bank of Sri Lanka, 2022).

Fundamental shortcomings in governance and regulation, as well as sociocultural norms that implicitly permit illicit financial flows, further compound these difficulties in the Sri Lankan context. Nepotism, bribery, and embezzlement are examples of poor governance practices that have eroded public trust in financial institutions and compromised regulatory frameworks. Due to the limited resources and antiquated technological infrastructures of enforcement agencies, this situation facilitates money laundering, allowing illicit funds to infiltrate and jeopardise the stability of the banking system (Smith, 2023). In light of this bleak situation, the Central Bank of Sri Lanka and the Financial Intelligence Unit have taken some

positive steps by strengthening the law, enforcing severe penalties for noncompliance, and strengthening their supervisory framework. However, significant technological and operational shortcomings impede advancement in crucial areas. The urgent modernisation of Sri Lanka's AML and CFT frameworks is necessary due to the absence of comprehensive regulations covering digital finance, fintech, and new payment methods, which exacerbates vulnerabilities in AML controls (Central Bank of Sri Lanka, 2022; Deloitte, 2025). A diverse, technology-driven, and cooperative approach to AML compliance is required for Sri Lanka to maintain the profitability and financial stability of its banking sector. This approach should encompass not only regulatory enforcement but also resource enhancement, inter-agency coordination, and cultural transformation to restore resilience and trust.

MATERIALS AND METHODS

To examine the effects of corruption and money laundering on the stability and profitability of all 24 licensed commercial banks in Sri Lanka between 2016 and 2024, this Study employs a descriptive research design based on the positivist paradigm and the deductive method. The total population of licensed banks is sampled using a census method, thereby enabling comprehensive analysis. Secondary data are sourced from Transparency International and the Basel Institute of Governance for corruption and money laundering indicators. In contrast, bank-specific financial data are extracted from annual reports on profitability, stability, size, and management efficiency. To control for endogeneity, the Corruption Perceptions Index is adjusted for bank size. Descriptive statistics, correlation, and regression techniques are used in E-Views 10 to ensure reliable assessments of the proposed relationships. Additionally, panel data were utilised in this Study. The Study also examined the effects of money laundering and corruption on bank stability and profitability, controlling for bank size and management effectiveness.
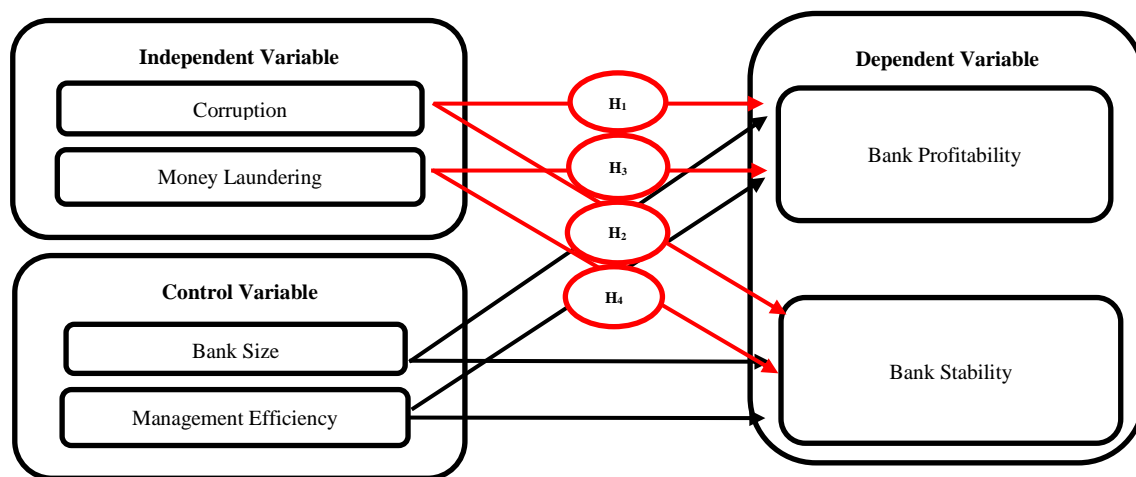

Figure 1. Conceptual Framework
Source: Compiled by Author, 2025

Operationalisation of Variables

Table 1. Measurement of Variables Employed

	Variable	Sign	Measurement / Reference	Source
Independent Variables	Corruption	CORR	Corruption Perceptions Index (CPI) score for Sri Lanka, divided by each bank's total assets. (Zaman et al., 2023)	Transparency International
	Money Laundering	ML	Anti-Money Laundering (AML) index for Sri Lanka, divided by the total assets of each bank. (Zaman et al., 2023)	Basel Institute of Governance
Dependent Variables	Bank Profitability (Return on Assets)	ROA	Net income divided by average total assets for each bank. (Zaman et al., 2023)	Annual Reports of Banks
	Bank Stability	BSTAB	Z-score = ROA plus earnings to the total asset ratio/standard deviation ROA (Qasim, 2020).	Annual Reports of Banks
Control Variables	Bank Size	BSIZE	Natural logarithm of total assets for each bank per year (Zaman et al., 2023).	Annual Reports of Banks
	Management Efficiency	MEF	Operating income divided by operating expenses (Xie et al., 2019)	Annual Reports of Banks

Sources: Compiled by Authors from Various Literature (2025)

Model Specifications

To analyse the impact of corruption and money laundering on the financial performance and bank stability of Sri Lankan licensed commercial banks, the Study utilises the Corruption Perceptions Index (CPI) and the Anti-Money Laundering (AML) Index as principal indicators. Both indices are adjusted for each bank's size, ensuring that the metrics account for institutional heterogeneity. Two empirical models have been developed to explore these relationships in depth. The first regression model assesses the impact of corruption and money laundering on bank profitability. The second model

investigates how these same factors influence bank stability.

$$ROA_{i,t} = \alpha_0 + \beta_1 CORR_{i,t} + \beta_2 ML_{i,t} + \beta_3 BSIZE_{i,t} + \beta_4 MEF_{i,t} + \varepsilon_{i,t.} \text{ (1)}$$
$$BSTAB_{i,t} = \alpha_0 + \beta_1 CORR_{i,t} + \beta_2 ML_{i,t} + \beta_3 BSIZE_{i,t} + \beta_4 MEF_{i,t} + \varepsilon_{i,t.} \text{ (2)}$$

With:
ROA - Return on assets
BSTAB - Bank stability
CORR - Corruption
ML - Money laundering
BSIZE - Bank size
MEF - Management efficiency
Hence, the regression was used to test the hypotheses of the Study, which may result in the following:

- Tests the hypothesised impacts of corruption and money laundering on profitability and stability regarding licensed commercial banks in Sri Lanka.
- Supports the evaluation of policy implications, a central objective of the Study.

RESULTS
The results test the impact of corruption and money laundering on profitability and stability, revealing the hidden risks these illegal activities pose to financial health.

Descriptive Statistics
Table 2. Descriptive Statistics Analysis

Variable	Mean	Std Dev	Min	Max	Observation
ROA	0.099	0.376	- 0.024	2.677	216
BSTAB	-1.131	0.945	- 2.328	2.584	216
CORR	1.465	0.190	1.159	2.264	216
ML	0.258	0.039	0.185	0.428	216
BSIZE	25.486	2.553	16.638	29.342	216
MEF	2.517	1.324	0.489	10.959	216

Table 2 shows descriptive statistics for 216 observations across key variables. The average bank profitability (ROA) is 0.099 with moderate variability. Stability (BSTAB) has greater variation, with a mean of -1.131. Corruption levels are consistently high, with a mean of 1.465. The risk of money laundering is moderate, with a mean of 0.258 and low variation. Bank size and management efficiency also differ significantly across institutions. These findings lay a strong foundation for examining the impact of corruption and money laundering on the financial health of Sri Lankan banks.

Correlation Analysis
Table 3. Correlation Analysis

Variables	ROA	BSTAB	CORR	ML	BSIZE	MEF
ROA	1.000					
BSTAB	0.072	1.000				
CORR	0.145	-0.031	1.000			
ML	0.127	0.033	0.915	1.000		
BSIZE	-0.211	-0.023	-0.947	-0.845	1.000	
MEF	0.102	0.179	0.131	0.050	-0.220	1.0000

The correlation analysis in Table 3 reveals that bank profitability (ROA) exhibits weak positive correlations with stability (r = 0.072), corruption (r = 0.145), money laundering (r = 0.127), and management efficiency (r = 0.102). However, it has a negative correlation with bank size (-0.211), suggesting that larger banks may have slightly lower profitability. Stability (BSTAB) has a weak negative correlation with corruption (-0.031) and a weak positive correlation with money laundering (0.033). It also has a stronger positive link to management efficiency (0.179). There is a robust positive correlation (r = 0.915) between corruption and money laundering. Both show strong negative correlations with bank size (r = 0.947 and r = -0.845), indicating that larger banks face lower risks of these illegal activities. These mixed relationships illustrate the complex effects of corruption and money laundering on the profitability and stability of Sri Lankan banks, highlighting the hidden financial risks they create in the sector.

Regression Analysis
Table 4. Regression Analysis - ROA

Dependent Variable: ROA				
Independent Variables	Coefficients	Standards Errors	T-Statistics	P-Values
CORR	- 1.1600	0.5511	-2.10	0.003
ML	0.6455	1.6310	0.39	0.002
BSIZE	- 0.1040	0.0321	-3.23	0.014

MEF	0.0058	0.0201	0.28	0.772
Constant	4.2684	1.4408	2.96	0.003
No. of groups	24			
No. of observations	216			
P-value	0.0000			
R-squared	0.2649			
Adj R-squared	0.2649			

Table 04 shows that the regression analysis of Bank profitability (ROA) reveals a significant adverse impact of corruption (CORR), with a coefficient of -1.1600 and a p-value of .003, indicating that higher levels of corruption negatively affect profitability. Money Laundering (ML) shows a significant positive relationship with profitability, as it is positively correlated with ROA (coefficient = 0.6455, p-value = .002). Still, the nature of this positive relationship to ROA may be complex. Bank Size (BSIZE) shows a negative correlation with ROA, with a coefficient of -0.104 and a p-value of 0.014, suggesting that larger banks are less profitable than smaller ones. In contrast, there is no significant relationship between Management Efficiency (MEF) and ROA, as indicated by a coefficient of 0.0058 and a p-value of 0.772, suggesting that Management Efficiency is not meaningfully related to ROA in this model. The overall model is statistically significant (p-value = 0.0000); it accounts for approximately 26.5% of the variance in ROA ($R^2 = 0.2649$) and confirms that these factors are relevant to bank performance in Sri Lanka.

Table 5. Regression Analysis – BSTAB

Dependent Variable: BSTAB				
Independent Variables	Coefficients	Standards Errors	T-Statistics	P-Values
CORR	- 4.7018	1.3736	-3.4229	0.000
ML	12.5713	4.0649	3.0927	0.002
BSIZE	- 0.1644	0.0801	-2.0519	0.004
MEF	0.1286	0.0501	2.5700	0.010
Constant	7.5159	3.5908	2.0931	0.037
No. of groups	24			
No. of observations	216			
P-value	0.0000			
R-squared	0.0888			
Adj R-squared	0.0715			

Table 5 follows a Fixed Effects approach to examine how corruption, money laundering, bank size, and management efficiency determine bank stability (BSTAB). This model explains only about 9% of the variation in stability, with an R-squared of 8.88%. Hence, other important factors are at work. Both corruption and bigger bank size from the results decrease stability (coefficient = -4.7018, p < 0.01, and coefficient = -0.1644, p < 0.01, respectively), while money laundering shows a strong positive relationship to stability, probably due to how regulations and sector-specific factors interact; its coefficient is 12.5713, with p < 0.01. Management efficiency increases bank stability (coefficient = 0.1286, p < 0.05). Therefore, effective leadership is crucial in banking institutions. Overall, these findings have highlighted that corruption and illegal financial activities can silently yet significantly shape the banking industry in Sri Lanka. The results demonstrate that targeted policies are required to enhance supervision and reduce risks within the system.

Hypothesis Testing
Table 6. Hypothesis Testing

	Hypothesis	Results	Decision
H_1	There is a Significant Impact of Corruption on the Profitability (ROA) of Licensed Commercial Banks in Sri Lanka.	0.003	Accepted
H_2	There is a Significant Impact of Money Laundering on the Profitability (ROA) of Licensed Commercial Banks in Sri Lanka.	0.002	Accepted
H_3	There is a Significant Impact of Corruption on the Stability of Licensed Commercial Banks in Sri Lanka.	0.000	Accepted
H_4	There is a Significant Impact of Money Laundering (ML) on the stability of Licensed Commercial Banks in Sri Lanka.	0.002	Accepted

DISCUSSIONS
The empirical findings of this Study provide a critical quantification of the shadow cast by financial crimes on the Sri Lankan banking sector. The primary objective was to determine whether corruption and money laundering have a significant influence on the profitability and stability of Licensed Commercial Banks (LCBs). The results provide strong support for the original primary hypotheses, although the nature of the relationships necessitates careful interpretation within the local context. Corruption and money laundering are closely linked to Sri Lanka's banking sector, which is why they affect the financial health, profitability, and stability of its licensed commercial banks through both overt and subtle means. It is generally accepted that corruption is a significant factor contributing to the decline in the sector's profitability and stability.

The regression analysis provides strong support for H_1 and H_2, confirming that corruption significantly reduces profitability and stability. This is supported by numerous sectoral studies and reliable empirical research, which align with

the majority of the Study's outcomes. The current research corroborates the strong negative influence of corruption on profitability, as reflected in ROA, with a p-value of 0.003. In terms of stability, as indicated by BSTAB, the adverse effect of corruption is even stronger, with a p-value of 0.000. The research aligns with this, as it identified pervasive corruption as a leading cause of underperformance among Sri Lanka's licensed commercial banks and, consequently, of the banking sector's financial fragility. Moreover, the same situation exists in other parts of Asia. Nasreen et al. (2024) note that the negative impact of corruption, a factor contributing to the constant decline in profitability and instability in banks, necessitates a more transparent environment and improved regulatory quality to mitigate it. Theoretically, this supports Agency Theory, suggesting that corrupt managers or politically connected lending lead to a misallocation of capital and an increase in non-performing assets, thereby eroding the balance sheet.

The conclusions drawn are further reinforced by Rehman et al. (2024), who demonstrate that corruption not only increases the level of non-performing loans but also deteriorates asset quality, thereby increasing credit risk, which ultimately becomes a systemic threat to the integrity and stability of the financial sector. The global picture indicates that research suggests corruption and political risks are among the significant factors weakening bank stability. However, not entirely, as competition and regulators often share the responsibility of serving as buffers against such impacts (Rehman et al., 2024). One of the core messages of the current investigation is that corruption is a universal factor that undermines banks' profitability and stability. The average corruption index (CORR) of 1.465 (SD = 0.190) and significant regression coefficients confirm these relationships.

Regarding the impact of money laundering, the Study found support for H03 and H04, but the direction of the relationship was unexpectedly positive. The coefficients for money laundering on ROA (0.6455, p = 0.002) and stability (12.5713, p = 0.002) suggest a statistically significant positive association. This result is complex and likely reflects a "short-term liquidity" effect described in the Economic Theory of Crime. In an environment where detection risks were historically low, the influx of "dark money" might have artificially boosted bank deposits and capital adequacy ratios, thereby appearing to enhance stability and profitability in the short term. However, in Pakistani studies, such gains are often a precursor to a "boom-bust" cycle, in which the eventual correction or regulatory crackdown poses systemic risk. The similarities between these results and global studies confirm that Sri Lanka is not an outlier, but rather a vivid example of how corruption acts as "sand in the wheels" of financial efficiency. The negative correlation between bank size and profitability (-0.1040) also suggests that larger Sri Lankan banks may face higher "compliance burdens" or be more prone to the inefficiencies associated with large-scale "shadow" activities, as suggested by Shah and Aish (2022).

The theoretical consequences of these findings are significant. They suggest that Institutional Theory's "isomorphic" behaviour may be prevalent in Sri Lanka, where banks comply with AML regulations on paper. At the same time, the underlying system remains vulnerable to corruption-driven distortions. Practically, the results emphasise that a "one-size-fits-all" regulatory approach is insufficient. The positive correlation between management efficiency and stability (r = 0.1286, p = 0.010) indicates that effective internal governance can buffer against the adverse effects of corruption. Among the factors that determine a bank's performance, bank-specific characteristics, particularly size and management efficiency, are key ones. The results of the present research indicate that larger banks have greater stability but lower profits. On the other hand, effective management increases both profitability and stability, although the latter's influence is weaker. These findings are further supported by Chakraborty (2024), who asserts that larger and more efficient banks are better at absorbing risk and consequently generate higher profits, a trend observable not only in India but also in South Asia. The regression outcome for bank size (BSIZE) and management efficiency (MEF) further reinforces these connections, with the respective coefficients being significantly negative and positive.

Ultimately, the results confirm that corruption and illegal financial activities are not merely legal issues, but fundamental drivers of economic performance. The Study demonstrates that while money laundering may provide deceptive short-term benefits, corruption is a universal drain on institutional resilience. Regulators must therefore focus on modernising AML frameworks covering digital assets and fintech, while simultaneously strengthening whistleblower protections and internal governance to mitigate the "unseen hand" of corruption.

CONCLUSIONS

The impact of corruption and money laundering on the stability and profitability of Sri Lanka's authorised and licensed commercial banks has been the primary focus of this Study. One of the main conclusions is that corruption has a detrimental impact on stability and profitability by eroding trust and increasing operational inefficiencies; over time, banks are most severely affected. Money laundering, on the other hand, has a more complex effect: it usually results in a drop in profits, but it may also temporarily stabilize the banking industry through the inflow of illicit funds and the concealment of even more severe governance issues.

The originality of this paper lies in combining a comprehensive study of corruption and money laundering in a single case, thereby providing banks in Sri Lanka with a vivid picture of the distinct and overlapping impacts of these two vices. It also reveals the twofold character of money laundering. Although this is contrary to most people's beliefs, in some cases it enables a bank to continue its operations in the very short run. The theoretical implication is a deeper understanding of the connection between illegal activities and the bank's performance, and it also highlights the need for context-specific models in financial crime research. The results at the management level emphasise that the banks' operations can only be secured through strong governance, extremely efficient internal controls, and strict compliance with AML regulations.

The Study has several shortcomings despite its contributions. The nine-year observation period may make it more difficult to identify long-term trends. The results' generalizability is limited by the focus on licensed commercial banks, which leaves out other financial institutions. The assessment of external influences may be affected by the exclusion of

broader macroeconomic variables and by the use of country-level indices, which may not accurately capture individual bank-level effects. Furthermore, the results are unique to Sri Lanka and might not be directly applicable to nations with different economic or regulatory environments. For more accurate results, future studies should use bank-level data, extend the study period, and expand the scope to include specialised banks. It is crucial to investigate emerging threats, such as AI-driven fraud, cryptocurrency scams, and cybercrimes. Staying ahead of evolving threats can be achieved by evaluating the efficacy of current mitigation strategies, such as cybersecurity frameworks and international partnerships. By utilising cutting-edge technologies like blockchain, artificial intelligence, and big data analytics, policymakers and banks can strengthen Sri Lanka's financial system through multi-layered defences that increase transparency, efficiency, and public trust.

REFERENCES

Basel Committee on Banking Supervision. (2010). *Principles for Enhancing Corporate Governance*. Retrieved from https://www.bis.org/publ/bcbs165.pdf

Becker, G. S. (1968). Crime and punishment: An economic approach. *Journal of Political Economy*, *76*(2), 169–217.

Bhargava, S., & Minoli, D. (2015). *Corruption, Governance, and Economic Growth*. Journal of Economics and Finance. https://doi.org/10.1007/s12197-015-9326-5

Central Bank of Sri Lanka. (2022). *AML/CFT Supervision and Enforcement*. Retrieved from https://www.cbsl.gov.lk

Chakraborty, S. (2024). *Bank Size, Efficiency, and Financial Stability in South Asia*. Journal of Banking Regulation. https://doi.org/10.1057/s41261-024-00250-1

Deloitte. (2025). *AML and CFT in the Digital Era*. Retrieved from https://www2.deloitte.com

DiMaggio, P., & Powell, W. (1983). *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality*. *American Sociological, 48*(2), 147-160. https://doi.org/10.2307/2095101

Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics, 3*(4), 305–360. https://doi.org/10.1016/0304-405X(76)90026-X

Qasim, Y. (2020). Z-score application for Jordanian Islamic banks. *Journal of Public Administration and Governance*, 10(1), 1–15. https://doi.org/10.5296/jpag.v10i1.16335

Malik, G. M. (2025). Theoretical foundations of money laundering and terror financing: conceptual analysis of legal frameworks and global challenges. "38th RSEP International Conference on Economics, Finance and Business, 30-31 January 2025, Atana Hotel, Dubai, UAE". https://doi.org/10.19275/RSEPCONFERENCES347

Masciandaro, D., Takats, E., & Unger, B. (2007). *Black finance: the economics of money laundering*. Edward Elgar Publishing.

Nasreen, S., Gulzar, M., Afzal, M., & Farooq, M. U. (2024). The role of corruption, transparency, and regulations on Asian banks' performance: an empirical analysis. *Journal of the Knowledge Economy*, *15*(2), 6475–6506. https://doi.org/10.1007/s13132-023-01153-8

Rehman, A., Mehmood, W., Alsmady, A. A., & Sharif, A. (2024). Corruption's impact on non-performing loans of banks in emerging markets: Empirical insights. *Research in Globalization*, *9*, 100241.

Shah, I. H., & Aish, K. (2022). A nexus between corruption, money laundering (ML), and inflation: evidence from South Asian countries. *Journal of Money Laundering Control*, *25*(4), 730–741. https://doi.org/10.1108/JMLC-09-2021-0096

Smith, K. D. (2023). Unveiling the Secrets of San Diego's FinTech: Insights into Anti-Money Laundering Strategies. Colorado Technical University.

Xie, F., Anderson, H. D., Chi, J., & Liao, J. (2019). Does residual state ownership increase stock return volatility? Evidence from China's secondary privatization. *Journal of Banking & Finance*, *100*, 234–251. https://doi.org/10.1016/j.jbankfin.2019.01.012

Zaman, Q. U., Akhter, W., Abdul-Majid, M., Hassan, S. I. U., & Anwar, M. F. (2023). Does bank affiliation affect firm capital structure? Evidence from a financial crisis. *Journal of Economic and Administrative Sciences*, *39*(1), 150–174.