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IMPACT OF CAPITAL STRUCTURE ON FINANCIAL PERFORMANCE OF SELECTED COMMERCIAL BANKS

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ABSTRACT

This study examines the impact of capital structure on the financial performance of selected commercial banks. Capital structure plays a pivotal role in financial decision-making, determining a firm's effectiveness and value. It encompasses the blend of equity and debt a company employs for financing operations. The study utilizes the debt-to-equity ratio to measure capital structure and financial metrics like return on equity, return on capital employed, net interest margin, and net profit margin to gauge financial performance. Five yearsof data (2017-2018) from five commercial banks were analyzed using statistical tools such as regression analysis and ANOVA via PSPP software to test hypotheses and draw conclusions. The study reveals a significant and positive correlation between the debt-to-equity ratio and return on equity, net interest margin, and net profit margin. However, an inverse relationship isobserved between the debt-to-equity ratio and return on capital employed.

INTRODUCTION

Capital structure is a topic that had attracted wide reach of researchers to work on it through out the earth. Capital structure is important principal in the process of making financial decisions that maximize effectiveness and worth of firm or enterprise. It is also referred to combination of various securities company uses to raise capital is simply known as capital structure funds can be raised both internally and externally and used to provide funding for operation throughout the business. Basically, sources are of two types: equity and debt to obtainfunding. When deciding on the capital structure, the company’s primary agenda is to reduce capital’s cost so that business increase its profits. It is important to identify variables influencing capital structure and its impact on financial performance in order to understand how banks finance their operations and what impact it has on banks' performance.

LITERATURE REVIEW

Niluthpaul Sarker &Roushnara Islam (2021) the author had made a attempt to illustrate theconsequences of structure of capital on bank’s profitability in developing nations. Panel data from 2009-2016 of 28 commercial banks was utilized know relation between capital’s structures with profitability. The capital’s structure is adversely associated with profitability.

The purpose of article by **Do Hoai Linh, Khai T Luong, Anh N H Mai, Linh A Dam, Ha TL Pham, and Nga T Nguyen (2022)** is to ascertain how capital’s structure affects the output of 85 manufacturing and processing businesses listed in Stock exchange of Vietnam from 2015to 2020. Profitability is assessed during the research using ROA and Tobin's Q, while structure of capital was assessed using STDA and LTDA. Growth and size serve as the controlling variables. The authors went on to say that STDA, LTDA, and ROA have a bad relationship. Tobin's Q and STDA do not significantly correlate, however LTDA had negative relationshipand presence of control variable have a beneficial impact on ROA and Tobin's Q.**Bindu C. (2021)** In this paper, capital's structure and profitability of Indian two- and three wheeler enterprises are compared. The study covered companies that were listed in BSE, and the data utilized to interpret it covered a 10-year period from 2007–080 to 2016–17. As a wayto gauge success, equity return was used. Long-term debt by total assets and long-term debt byequity were the study's independent variables. Economic methods like the fixed effects modeland random-effects model are used in investigation. The author also draws the conclusion that the capital's structure in Indian two- and three-wheeler enterprises has a considerable detrimental impact on their financial performance.

This empirical study by **Md Nur Alam Siddik1 , Sajal Kabiraj2 , and Shamungan Joghee3 (2017)** was conducted to explore the influence of capital's structure on economic performance of Bangladeshi banks. Panel information from 22 banks that are listed on Dhaka stock Exchange utilized to conduct study. Measures like ROA, ROE, and EPS are utilized to perform analysis. The empirical results imply that instead of excessively relying on loan capital, managers should aim to finance from sources like retained earnings. The financial outcomes ofbanks and capital's structure have an inverse relationship, as per results of least squares regression.

AM Goyal (2013) compared the structure of capital and operating results of listed public sectorbanks in India that are listed on NSE (National Stock Exchange). To ascertain how ROE, Returnon Assets, and EPS relate to capital structure, descriptive statistics, autocorrelation issues, and regression analysis are applied. The study came to the conclusion that short-term debt & profit potential of Indian banks are positively correlated. Finding the ideal capital's structure to increase the profit potential of the banks is made easier by the research findings.

Nirajini, A1 Priya K B2 (2013) attempted to determine effects of structure of capital on financial performance for period 2006 to 2010. The work was created for Sri Lanka's listed trading companies. The sample companies' annual reports are utilized to gather data. Correlation along with multiple-regression analysis is utilized in analysis. The findings imply a positive relation between capital's structure and fiscal success. The author went on to say thata company needs an effective structure of capital to turn a profit and operate profitably.

CAPITAL STRUCTURE THEORIES

Capital structure theories provide insights into how a company should finance its operations and investments. There are two main categories of capital structure theories: relevance theoriesand irrelevance theories. Here's a summary of each:

Relevance Theories:

1.Trade-off Theory : This theory suggests that firms strive to find a balance between the benefits and costs of debt. Debt offers tax shields but increases financial distress costs. Firms aim to determine the optimal debt level that maximizes their value.

2. Pecking Order Theory : The pecking order theory proposes that companies prefer internal financing (retained earnings) over external financing. When external financing is needed, firmsprefer debt to equity due to information asymmetry concerns. Thus, the capital structure evolves incrementally based on financing needs.

3. Agency Cost Theory : This theory emphasizes the role of agency conflicts between shareholders and management. Debt can help align interests by imposing discipline on management but may also lead to agency costs if managers prioritize short-term gains over long-term value.

Irrelevance Theories :

1. Modigliani and Miller Proposition I (with Taxes) : This theory argues that, in a world with taxes, the capital structure decision matters because interest on debt is tax-deductible, making debt financing cheaper than equity. However, the value of the firm is still independent of its capital structure in the absence of taxes.

2. Modigliani and Miller Proposition II (with Taxes) : This proposition builds on the first, stating that the cost of equity increases as the firm's debt level rises. The weighted average cost of capital (WACC) is minimized at the optimal debt level. Therefore, the capital structure doesmatter when taxes are considered.

In summary, relevance theories suggest that the choice of capital structure can impact a firm's value, considering factors like tax benefits and agency costs. Irrelevance theories, on the other hand, argue that capital structure is irrelevant in a world without taxes and other market imperfections. In practice, firms navigate between these theories to determine the optimal balance between debt and equity financing based on their unique circumstances and objectives.

Research Gap

Plentiful studies have carried out to probe relationship between capital's structure and financialperformance by various scholars around the world, and they have produced varying conclusions by taking into account various criteria. Following a analysis of the literature, it was discovered that a lot of study was made on different industries, including trading enterprises, manufacturing and processing firms, non-financial firms, the textile industry, and many more.There haven't been many studies on the banking industry, but the current study fills gap by going deep into how the capital's structure affects the output (performance) of particular institutions.

Objectives of study

1. To investigate how the structure of capital affects financial performance of specific banks.

2. To study significant relation between capital's structure & financial performance of specificbanks

3. To determine optimal capital structure that correlates with the highest performance.

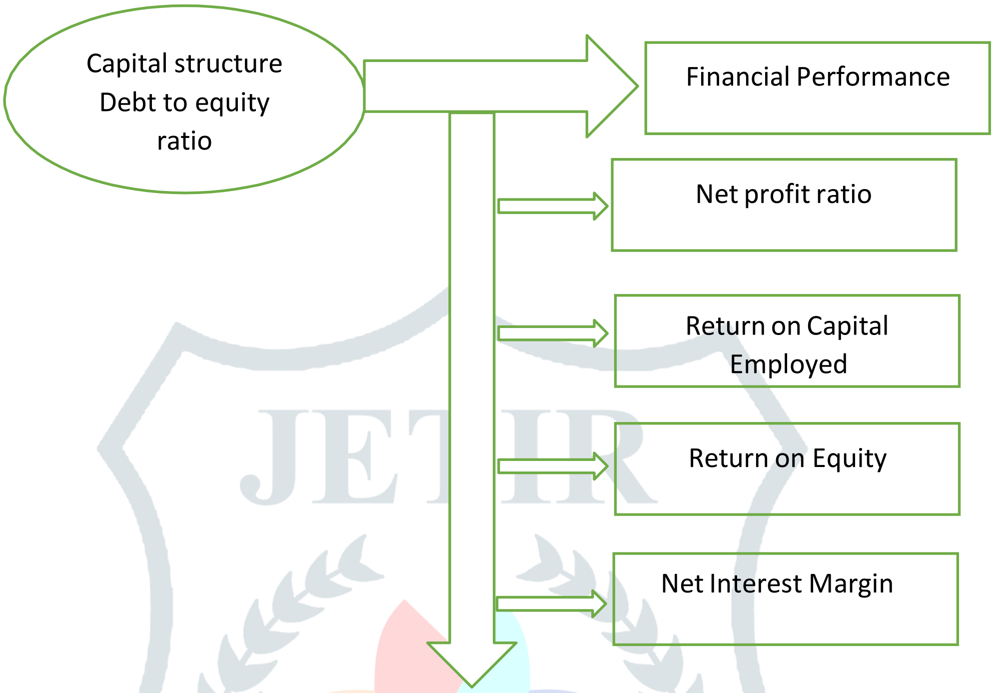
4. To advise banks how to boost profitability by adopting a better capital structure strategyframework.

Research MethodologyCollection of

Data

Secondary data were analyzed in current study. Secondary data refers to information or data that is collected and complied by someone else but the researcher still found it valuable for current study. The primary sources of data for study were the financial statements, which are composed of income statements and balance sheets from the sample banks. In addition, academic texts on the topic, search engines on the web, and scholarly papers from academic journals were used. Data sampling: Random sampling method is utilized to select the banks forinvestigation.

Research Design To ascertain effect of capital's structure on profitability, regression analysis was used. Here Profitability or fiscal performance is dependent variable, and capital's structure is independent variable. These independent and dependent variables are employed to know relationships listed below. Bank profitability is based on its capital's structure. The representation is as follows:



Hypothesis

1. H0: There is no significant impact of debt to equity on return on equity.
   H1: There is significant impact of debt to equity on return on equity.
2.H0: There is no significant impact of debt to equity on return on capital employed
   H1: There is significant impact of debt to equity on return on capital employed
3.H0: There is no significant impact of debt to equity on net interest margin
   H1: There is significant impact of debt to equity on net interest margin
4.H0: There is no significant impact of debt to equity on net profit margin
   H1: There is significant impact of debt to equity on net profit margi

Summary of research variables:

Sl no.	Variables	Formula	Symbol
1	Return on Networth	Equity Net Income / Total Equity	ROE
2	Return on capital employed	EBIT/ capital employed	ROCE
3	Net Profit margin	Net Income/Revenue	NPM
4	Net Interest margin	Net interest Income-Net Interest Expenses/ Average Interest -Earning Assets	NIM
5	5 Debt to equity	Total debt / Total Equity	DR

Consolidated table for data analysis and interpretation utilization of statistical tools likeRegression and ANOVA

Banks	Variables	Sig.	R Square	Remarks
State Bank of India	ROE	0.149	0.55	Positive
	ROCE	0.051	0.77	Positive
	NPM	0.243	0.41	Positive
	NIM	0.296	0.35	Positive
Punjab National Bank.	ROE	0.165	0.53	Positive
	ROCE	0.865	0.01	Negative
	NPM	0.156	O.54	Positive
	NIM	0.201	0.47	Positive
HDFC Bank	ROE	0.424	0.22	Positive
	ROCE	0.884	0.01	Negative
	NPM	0.069	0.72	Positive
	NIM	0.298	0.34	Positive
AXIS Bank.	ROE	0.864	0.01	Negative
	ROCE	0.595	0.11	Positive
	NPM	0.643	0.08	Positive
	NIM	0.282	0.36	Positive
ICICI Bank	ROE	0.424	0.22	Positive
	ROCE	0.884	0.01	Negative
	NPM	0.069	0.72	Positive
	NIM	0.298	0.34	Positive

Interpretation:

Above mentioned is a consolidated table for data analysis & interpretation which consists the banks selected for study. In which capital's structure is measured through debt-to-equity ratio and financial profitability or performance is measured through variables like returns on equity, returns on capital employed, net profit margin and net interest margins. R-square value, which represents extent to which variation due to independent variable in dependent variable. A higher R- square value indicates better fit for model. Table further confirms there's substantial and favorable influence capital's structure on financial performance. All variable show favorable relation except ROCE which shows inverse relation with three banks and ROE adverse relationwith one bank.

Findings:

Capital structure is very sensitive subject in financial management because it partly impacts its fiscal performance. The primary purpose for undertaking study is to examine how structure of capital impacts financial performance. Primary finding of work suggests capital structure exerts considerable influence on financial performance where debt to equity was substituted as proxy for capital's structure & returns on equity, returns on capital that is employed, net profit marginsand net interests margin were used as proxy for financial performance all variables had positive impact except The financial measure returns on capital employed had no influence on capital'sstructure when debt to equity is independent variable.

Suggestions:

In the present work financial performance and capital's structure is measured using the limitedvariables and there may be other variables may also be relevant impact fiscal performance of banks. To enhance study's value, it is essential to conduct it while considering various variables. Although numerous banks exist in India, only five banks are chosen. Only few methods were used to analyses and interpret the data there are other tools which can be utilizedlike correlation, descriptive statistics and many others. The study is carried for one sector i,e banking sectors. To have a wider view, the study can be conducted in different sectors to have a generalized result. State bank of India has relatively better capital structure among the selected banks as financial performance indicators positively influenced by tested variables and also from collected it indicates bank has more debt than equity which had favorable impact on financial performance through selected variables. It is also suggested having capital's structure similar to SBI might be profitable as it boosts financial performance.

Conclusion:

Study is focused on investigating influence of structure of capital on financial performance of specific banks in India. The involved analyzing five banks for a duration of five years. Structure of capital is measured through debt-to-equity ratio while fiscal performance is measured through variables like returns on equity, return on capital employed, net profit margin and net interest margin. Regression model is utilized to carryout study and know its impact. Here Rsquare value, which represents percentage of variation in dependent variable due to independent variable. A higher R- square value indicates better fit for the model. The ANOVA table further concludes there is a substantial and positive impact of capital's structure on financial performance. All variables show a favorable relation except ROCE which shows adverse relation with three banks and ROE s negative relation with one bank.

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