# Impact of Capital Structure on Banking Performance

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**Abstract**
This paper examines the impact of capital structure on bank performance. The study spreads empirical work on capital structure determinants of banks within country and foreign country. Multiple reversion models are useful to evaluation the relationship between capital structure and banking performance. Performance is measured by return on assets, return on equity and earnings per share. Determinants of capital structure contains long term debt to capital ratio, short term debt to capital ratio and total debt to capital ratio. Results of the study validated a positive relationship between factors of capital structure and performance of banking industry.
**Keywords:** Banking Performance, Optimal Capital Structure, Return on Assets, Return on Equity, Earning Per Share.

## 1. Introduction

Many researcher debates on the impact of capital structure on banking performance in the world. The good determine the performance is financial statement of any bank. The financial statement is positively effect on banking performance. Some researcher found that financial statement is good impact on banking performance. Some researcher debate that good relationship b/w capital structure and banking performance. The main attract to capital structure on banking performance is new technologies. By new technologies develop then the productivity of any bank increase and shown good results. Some researcher debate on variable which use in the capital structure on banking performance such as investment and size of bank etc. Different theories adopt between capital structure and bank performance and shown good results.

Capital structure is the important topic in finance. The process of measure of capital structure is very hard to any banks. The managers of banks are facing difficulties in determining the capital structure. Pakistani banks are facing many problems in financial field such as political problem. Because no educated person resources and low quality of services and products.

Modigliani and Miller (1958) debate that capital structure is important decision in financial field. In (1970) Pakistani banking industry was on top. In Pakistan the financial sector became good industries. Due to political impact the negative impact on investment of any bank.

Capital structure of the group is very hard to determine. Financial managers are fronting difficulties in just determining the optimal capital structure. Optimum capital structure means with a minimum weighted average cost of capital and thus maximize the value of organization. A business utilizes several kinds of financing to operate a company efficiently. Pakistanis financial field practical exciting modifications since independence in 1947. At first it was hurt by political and socioeconomic problems. Unsatisfactory educated human sources and professionals resulted in to low quality connected with services and products. Financial aspect is a tool which point out the financial strengths, weaknesses, opportunities and threats. On the additional hand today capital structure is one of the most significant financial decisions for any business and firm. This decision is authoritative because the organizations need to expand return to different organizations and also have an effect on the value of the organization. The financial sectors of the Pakistan became one of the most significant industries in the country. Due to that very reason it has a negative effect on investment environment in banking industry. The purpose of leading the study is to measure the effect of capital structure on banking performance to provide experimental. The topic of capital structure has been one that has inundated the academic world for a number of years. There have been many works published on the subject which have presented such theories. A need was identified to explore the impact that capital adequacy has on a bank's performance and whether it achieves its purpose of increasing constancy amongst banks. This study analyzed the determinants of the capital structure of banks in financial data and by performing this analysis attempted to establish trends in capital structure policy and regulatory compliance. The study also attempted to identify best practices that contribute to the overall value and performance of the banking organization. The hope is that the right application of capital structure theory and agreement with principles will decrease a bank's risk. Overall, the results of the analysis were unsatisfying, but lay the basis for potential future research.

## 2. Literature Review

The impact of capital structure on bank performance has been a topic of debate between researcher and scholar. Different researchers have been conducted to explore the impact of capital structure on bank performance. Different researchers used different techniques and methodologies and there have been different opinions about the results. Some researchers find that there is positive impact of capital structure on bank performance. Different tools used to determinates of capital structure of bank in financial and non-financial as the study of Jensen and Meekling (1976). They found different problems to measure the capital structure. Harris and Raviv (1991) Mayers 2001 have conducted different theories to measure the capital structure. There is a positive relationship between capital asset ratio and earnings of the bank by study berger (1995). Different banks have high loan problems and bad quality loans. The banks are highly levered to comparing the non-financial firms.

Basically this paper is related to the literature on 1) relationship between bank capital and bank performance 2) what effect of capital structure on bank performance 3) risk measuring. Many papers include to the literature on the relationship between bank capital and bank performance. Many papers effect on capital structure on bank performance. The effect of capital structure on bank performance is positive. Different researcher measure the risk from equity and debt of bank. A big role to finds the relationship between bank management cost efficiency. The researchers are using more data about to measuring the risk.

Due to performing of these practices, banks have positive impression all the parties' not only interested parties. A positive image created in the mind about bank if low risk involve. The result of these consequences to improving the financial performance and good relationship between bank capital and bank performance.

In spite of different researchers Deesomak (2007) found that impact of capital structure on bank performance to be negative. Some researcher as Modigliani and miller (1958) debate in corporate finance theory. They interpret those theories. 1) trade-off-theory 2) traditional theory. In traditional theory when minimized the weighted average cost of capital and maximize the market value. In trade-off-theory includes taxes and agency cost. They focus only on positive relationship between capital structure and bank performance. They use both internal and external sources to measuring the performance of banks. There are many sources about debt and equity. In which include long term debt and short term debt on corporate debt and also include long term debt and short term debt on government debt. Different variable used in this topic: such as independent variables and dependent variables.

### *2.1 Leverage Ratio*

Leverage use in capital structure to increase the risk. There are closely related concepts between leverage and capital structure. We understand easy to measure and evaluate leverage particular in decision making for capital structure. Three types of leverage 1) operating leverage 2) financial leverage 3) Total leverage. Operating leverage is the relationship between sales revenue and earnings before interest and taxes. Financial leverage is the relationship between earnings before interest and taxes. Total leverage is the relationship between sales revenue and earnings per share.

### *2.2 Earnings Ratio*

We measure the risk using to different tools. As measuring of risk the important role of behavioral finance. As a previous work if we take high risk then the result will be high return and if we the low risk then the result will be low return. If debts of banks increase daily then the badly effect on the banking performance. We collect different information about banks. In which including information about employment grade, occupation and also include monthly and weekly working time. By study Berger (2002) the banks who are create more profit efficiency there riskier bank. By study Keely and furlong the value of banks maximize if the banks adjust earning risk and the banks easily identify changes in earning in the capital structure. If any bank has more debt than the bank take loan from other banks and decrease the debt.

*2.3 Size*

This is the real variable and shows bank's size. By study Pratomo and Ismail (2007) the negative effect of size on banking performance. The bank size affected by quantity so the bank measuring the size of bank. Many employee work in the bank and they have different opinion. If they give good progress then the risk of bank automatically decrease. We should increase the pay of those employees who give good progress. This is why good relationship creates among the employees and they will give good progress in future. By study Evans and Leighton (1989) if the risk of employment negatively affect with bank size then enhance the relationship between them.

*2.4 Bank Investment*

When any person invests in bank firstly they saw risk of bank. Many researcher debates on banks investment. Firstly they cannot good decision about the value and profitability of banks. As study Allayannis and Weston the positive relationship between bank value and foreign currency. Before invest in bank we gather many ideas from different people. The point of view of different researcher the bank should equal the risk and capital. The result is if banks hold capital then the risk can decrease. Different researcher debates on investment in banks that is the key to measure the performance of banks. Berger (2002) resulted that we measure banking efficiency that effect on investment.

*2.5 Loans*

Different researcher debates on this variable. By study Muhammad Ayub Siddiqui and Adnan Shoaib we determine market value and efficiency of banks by loan. It totally depends on the quality of bank. By Berger and De young (1997) search relationship between efficiency of bank and loans.

*2.6 Bank Efficiency*

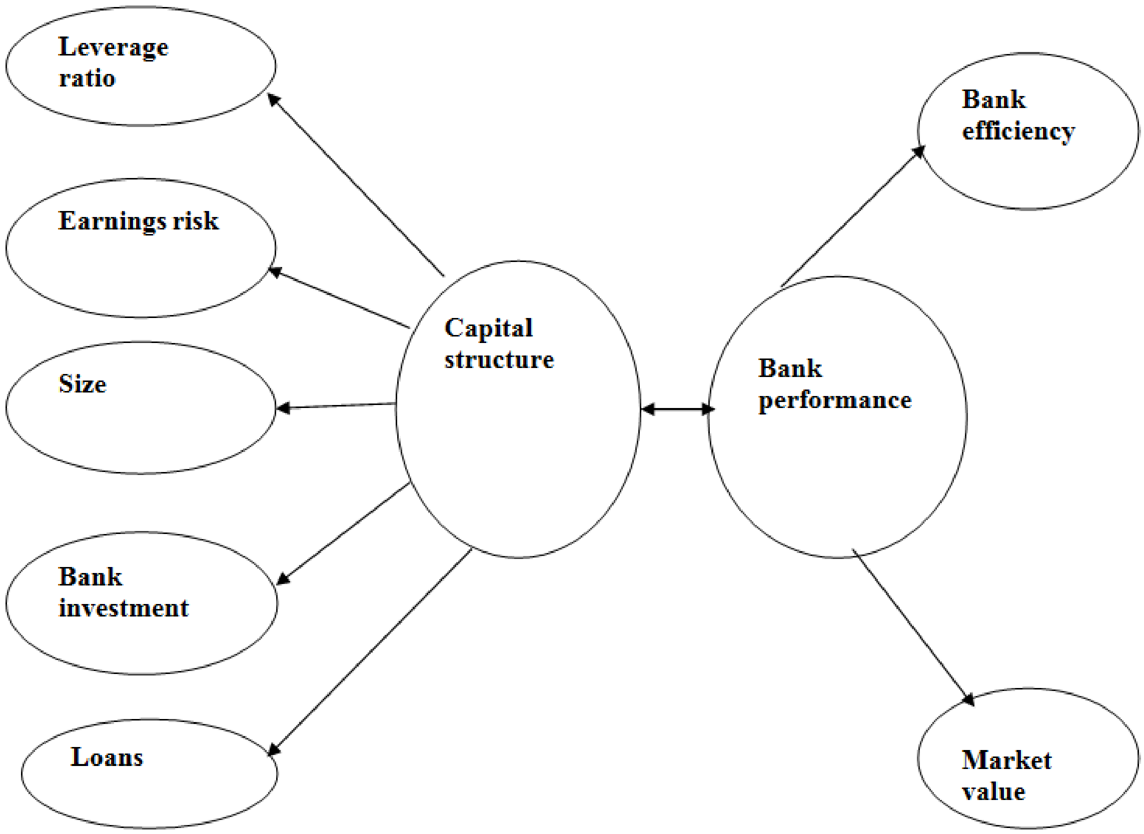
Through bank efficiency we can easy measure of bank's ability and revenue. It is important to different banks. By researcher we should focus only on cost of bank and profit margin. The profit margin should be low. Different researcher debates on low efficiency and high efficiency. Some researcher discussion on this topic such as Wall (1985) some banks occurred in 1970 to 1980. In which its research that no interest only on profitability banks. By study Gup and Walter they focus only on small banks in which they investment highly quality and low cost.

The past study by Critchfield, Davis, Davison, Gratton, Hanc, and Samolyk (2005) they focus only performance of bank. The result is that good decision about income and quality of banks. Firstly we understand the operation of bank because different banks have different criteria. If the manager clearly manages the rules of bank then the efficiency of bank can increase. We should not show high profit although focus only on performance of bank. This is strategic variable in which management control the direction.

*2.7 Market Value*

In simply when the weighted average cost of capital minimized when market value of asset maximized. When prices of market increase then the value of market is also increase. Researchers have different ideas use in research.

## 3. Theoretical Framework




## 4. Methodology

In order to draw some of the results from my research project first i have developed some hypothesis related to my research and in other step using my selected methodology i accept or reject these hypotheses. Followings are these Hypotheses.
H1- There is a positive relationship between firms Capital structure and bank performance.
H0- There is a negative relationship between firms Capital structure and bank performance.

### *4.1 Proposed Methodology*

The study utilizes the data from banks from 2008 to 2012. The study uses the descriptive analysis to find the results because our research is going to find the results of different variables in years from 2008 to 2012. I solve precise problems to used empirical method. I collect secondary data and used regression model. The purpose of our study is to evaluate the performance of difference variables in different time periods to check the relationships that what impact of capital structure on banking performance. I had found out the relationship between capital structure and the banks performance. For the purpose of checking the relationship between Capital structure and bank performance wealth I used the ROE, ROA and EPS of different banks. I apply statistical tools on the data to inference the research result in quantitative notation. Moreover I had done a literature survey about that area of research to identify the relationship between Capital structure and Firms performance of banks. By using the above discussed methodology I reject or accept the hypothesis that I am generated. Capital structure, bank performance, bank size, earning risk, bank loans are independent variable and bank efficiency is dependent variable and I had found out the relationship between these Independent and dependent variable. The collected data was performed to identify the capital structure of Pakistani banks. I used descriptive method that what impact of capital structure on banking performance. The purpose of my research paper that measure the performance of banks.

## 5. Results & Findings

**Descriptive Statistics**

| | N | Minimum | Maximum | Mean | Std. Deviation | Variance |
|---|---|---|---|---|---|---|
| ROE | 30 | -1.9894E2 | 29.4300 | .158667 | 56.9527372 | 3.244E3 |
| ROA | 30 | -5.4100 | 3.4700 | 1.148000E0 | 1.9812734 | 3.925 |
| EPS | 30 | -19.0200 | 24.4700 | 9.717000E0 | 10.9778426 | 120.513 |
| DTEQ | 30 | 6.8500 | 51.0100 | 1.678800E1 | 11.3549192 | 128.934 |
| Valid N (list wise) | 30 | | | | | |

In above table researchers used descriptive statistics and measured mean, Std. Deviation and Variance of some variable such as dependent variable ROE, ROA, EPS and independent variable debt to equity ratio.
Now researchers measure the relationship between two variables.

H1: $p < 5\%$ then accept
H0: $p > 5\%$ then not accept

**Coefficients**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | t | Significant |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | 54.716 | 14.556 | | 3.759 | .001 |
| | DTEQ | -3.250 | .722 | -.648 | -4.501 | .000 |

a. Dependent Variable: ROE

In this table researchers measured performance between return on equity ROE and debt to equity and the Positive significant value of less than 0.005 shows the positive relationship between capital structure and banking performance.
H1: $p < 5\%$ then accept
Debt to equity and ROE: At level of confidence the significant value less than 5% so can be accepted.

**Coefficients**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Significant |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | 3.121 | .491 | | 6.353 | .000 |
| | DTEQ | -.118 | .024 | -.674 | -4.824 | .000 |

a.
ependent Variable: ROA

In this table researchers measured performance between return on asset ROA and debt to equity. The positive significant value less than 0.005 shows the positive relationship between capital structure and banking performance.
H1: $p < 5\%$ then accept.
Debt to equity and ROA: At level of confidence the significant value less than 5% so can be accepted.

**Coefficients**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Significant. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | 21.828 | 2.452 | | 8.901 | .000 |
| | DTEQ | -.721 | .122 | -.746 | -5.931 | .000 |

a. Dependent Variable: EPS

In this table researchers measured performance between earning per share EPS and debt to equity. The positive significant value less than 0.005 shows the positive relationship between capital structure and banking performance.

H1: $p < 5\%$ then accept.

Debt to equity and EPS: At level of confidence the significant value less than 5% so can be accepted.

## 6. Conclusion

In this paper researchers studied about the impact of capital structure on bank performance. The core purpose of this study is to measure the performance of all banks. Researchers have measured the performance over the time period from 2008 to 2012. The results showed that capital structure has positive impact on bank performance. The significant levels are positive between dependent variable and independent variable which i used in my paper such as ROE, EOA, EPS and debut to equity.

The performance of banks can be improved if they adopt the following given points.

- Good technology adopt
- Employee skills
- Time management

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