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IMPACT OF CAPITAL STRUCTURE ON THE PROFITABILITY OF SELECTED COMMERCIAL BANKS OF NEPAL

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ABSTRACT:

The banking sector of Nepal has experienced a rapid change after the economic liberalization. Various commercial banks are operating in Nepal after the Nepal government adopted the open, liberal and market oriented economic policy. However, the financial sector has not been responsive enough to meet the growing need of the economy as expected. The study is aimed to examine the impact of capital structure on the profitability of selected commercial banks of Nepal.

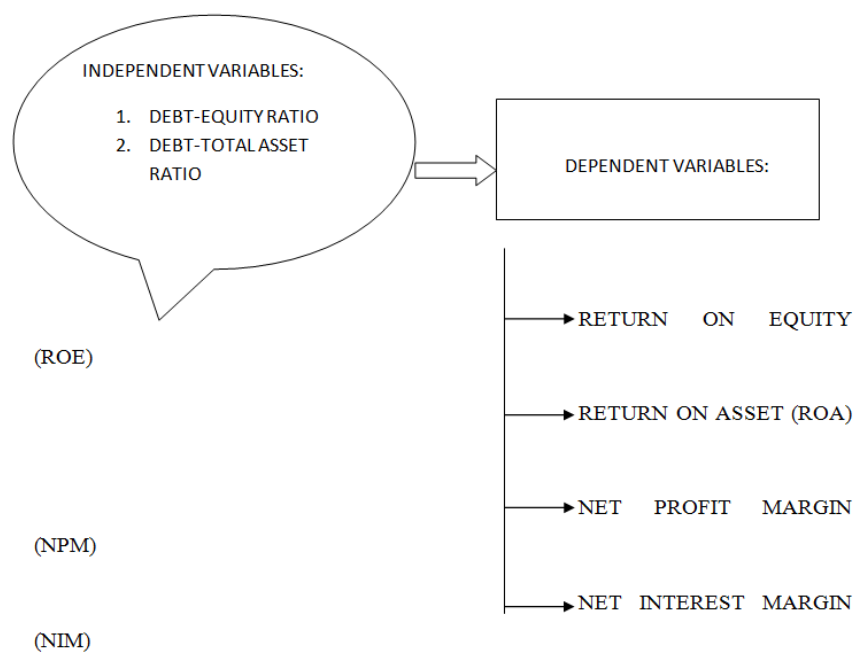
KEYWORDS: *Capital Structure, Commercial Bank, Economic Liberalization, Financial Institutions.*

INTRODUCTION:-

The history of banking in Nepal dates back to the year 1937 AD with the establishment of Nepal Bank Limited as the first commercial bank in Nepal. It was established as a semi-government bank with METALLIC COINS worth NRs 10 million as the authorized capital. Banknotes in Nepal weren't introduced up until the mid-1940s. It was in the year 1945 that the earliest banknotes were issued by the treasury "Sadar Muluki Khana". These notes were signed by a "Khajanchi", the head of the treasury who also was a high Hindu Priest.

Later in the year 1955, Nepal Rastra Bank Act was formulated for a better banking system and Nepal Rastra Bank was established in 1956 as the Central Bank of Nepal accordingly. After this date, the banknotes were issued by the Central Bank with the signatures of the governors of the institution. Till the 1980s, the banking sector was wholly owned by the government, with Agriculture Development Bank, Rastriya Banijya Bank, NBL and NRB being the pillars of financial institution in Nepal. 1984 saw the start of the private banking industry with the establishment of Nepal Bank and the introduction of foreign banks such as the Nepal Arab Bank, Nepal Indosuez Bank and Nepal Grindlays. The banking sector in Nepal has faced many hurdles and hindrances. It has undergone various political conflicts and instability. But today, it stands

more liberalized and modernized. There are various types of banks working in the modern banking system in Nepal. As per the list issued by NRB as of Mid-June 2018, the modern banking sector includes 28 Commercial Banks, 33 Development Banks, 25 Finance Companies, and 63 Micro Credit Development Banks. Based on the research questions, the following conceptual model has been constructed. This model introduces two independent variables of capital structure i.e. debt-equity ratio and debt to asset ratio whereas the measures of profitability i.e. ROE, ROA, net profit margin and net interest margin have been chosen as dependent variable.



LITERATURE REVIEW

David Durand (1959), Modigliani and Miller (1958), Donaldson (1961), Alchian Kessal (1959), Schwartz and Ezra Soloman (1978) and other have made a great contribution to the development of theories at capital structure. A great deal of controversy has developed over whether the capital structure of a firm as determined by its financing decision affects its cost of capital. Traditionalists argue that the firm can lower its cost of capital and increase the market value per share by the judicious use of leverage. Modigliani & Miller (1958), on the other hand, argue that in the absence of taxes and other market imperfections, the total value of the firm and its cost of capital are independent of capital structure. There are four major theories explaining the relationship between capital structure, cost of capital and value of the firm:

1. Net Income Approach,
2. Net Operating Income Approach,
3. Traditional Approach and
4. Modigliani-Miller Approach.

Some useful literatures related to capital structure management have been reviewed. The main purpose of reviewing these articles and journals is to gain an idea on the research studies conducted earlier and what remains to be done. This provides a foundation for developing comprehensive theoretical framework and hypotheses for testing.

Hussain Muhammad , Bahadar Shah and Zia ul Islam(2014): the main objective of this study is to empirically investigate the impact of capital structure on firm's performance using 25 percent companies listed on Karachi Stock Exchange during 2009-2013.

The result of the study shows poor performance of listed cement companies because of high debt financing. This study also shows the negative relation between debt to assets and firm's performance whereas it shows the positive relation between debt to equity and firm's performance.

Sailaja and Madhavi(2015): this study aims to examine the effect of capital structure on profitability of private and public sector banks along with comparison of their financial performance.

The study shows that the overall performance of private sector banks is better during the study period because debt to equity of public sector banks is higher than that of private sector banks. Hence, public sector banks are exposed to high degree of risk. It is also observed that in public sector banks, capital structure affects the earning per share (EPS).

Radhe S. Pradhan and Kabindra Pokharel(2016): the objective of this study is to analyze the capital structure factors affecting the financial performance of commercial banks in Nepal. This study is based on the pooled cross sectional data analysis of 19 commercial banks listed in NEPSE for the period of 2007/08 to 2013/14.

The study reveals that the total debt to total assets ratio, long term debt to total assets ratio, short term debt to total assets ratio and size are negatively related to ROA. It indicates that higher the debt in the capital mix, lower would be ROA. Similarly, increase in credit risk leads to an increase in ROA.

Marzieh Khodavandloo, Zukarnain Zakaria and Annuar Md. Nassir (2017): This study examines the impact of capital structure on Malaysian firm's performance in trading and service sectors using three accounting based performance indicators(ROE, ROA and GPM) and two market based indicators(EPS and PE). The result of the study shows a negative relation between financial leverage and performance. The relationship is observed more strongly during the global financial crisis period (2007-2009).

Sujata Timsina (2018): this study aims to examine whether the determinants of capital structure affect the leverage position of joint venture banks in Nepal. The researcher has selected 3 joint venture banks of Nepal for her study purpose.

The study concludes that there is no significant relationship between profitability (in terms of ROE) and leverage of all the three sampled banks. The study also reveals that the relationship of capital structure and profitability is significant for Everest Bank Ltd in terms of ROA. However, the relationship between capital structure and profitability is not significant for Himalyan Bank Ltd and Nepal SBI Bank in terms of ROA. Similarly, in terms of EPS, the relationship of capital structure and profitability is significant for Everest Bank Ltd and Himalyan Bank Ltd but not for Nepal SBI Bank.

In context of joint venture banks, very limited studies have been done regarding their capital structure. Most of the research done on joint venture banks has been found to be based on their formation structure or their overall financial performance. This study adds to existing literature the effect of capital structure specifically on joint venture bank's performance and profitability in context of Nepal. A valid and full-fledged research in the joint venture banking sector has not yet been done.

This study tries to provide an insight into the major drivers of capital structure management of joint venture banks in Nepal. Theories such as Net Income Approach, Net Operating Income Approach, Modigliani-Miller (MM) Approach and modern theories of capital structure such as pecking order theory and agency cost theory consider different determinants crucial for optimizing the capital structure. However, all these theories conclude on the same proposition of minimizing the overall cost and increasing the returns. This is possible through appropriate combination of debt and equity driven by factors such as size, growth, profitability, assets tangibility, liquidity and risk.

STATEMENT OF THE RESEARCH PROBLEM

Capital structure denotes the mode of finance, usually a blend of the debt and equity capital, through which a firm is financed. It has been an interesting issue for many researchers, wherein they attempted to delineate the connection between capital structure and performance of firms. The decision of how a firm is financed, is subjected to both the managers of the firms and fund suppliers. If financing is done by supplying an incorrect combination of debt and equity, a negative impact is seen in the performance and even endurance of the firm. Thus, in order to maximize the firms' value and profitability, managers need to carefully consider the capital structure decision, which is a complex task, as the use of leverage varies from one firm to another. Therefore, what managers usually do, is try to achieve best combination of debt and equity in their capital structure.

The financing decision mix of debt and equity represents a fundamental issue faced by financial managers of firms. The actual impact of capital structure on banks' profitability in Nepal has been a major problem among researchers that has not been resolved. There is still no conclusive empirical evidence in the literature about how capital structure influences banks' profitability in Nepal. However, banking sector of Nepal grew rapidly in the last decade, which created new and better opportunities in banking industry. However, the researcher in this research, tries to find out the answer to the following questions:

1. What is the current composition of capital structure of commercial banks in Nepal?
2. What is the influence of capital structure on banks' profitability?
3. What modifications can be done in the composition of capital structure of banks to improve their profitability and performance?

SIGNIFICANCE OF THE STUDY

This study is very favorable for those who want to know the impact of capital structure on the performance of banking industry and the relationship between capital structure variables and profitability variables. This study contributes to literature on capital structure and banks' profitability and performance in Nepal. The study will also guide banks in determining their optimal level of capital structure to achieve optimum level of banks' profitability in order to meet wealth maximization goal of the firms. Besides, it will also serve as a reference for other researchers in the area of corporate finance.

OBJECTIVES OF THE STUDY

Capital structure decision is one of the important planning tools to every financial organization for efficient and effective utilization of the funds to achieve its objectives. The main objective of the study is analyze the impact of capital structure on profitability and performance of joint venture commercial banks in Nepal. Under this basic objective, the following specific objectives are set:

- To examine the relationship between capital structure and profitability of commercial banks in Nepal.
- To explore the impact of capital structure decisions on the profitability of commercial banks in Nepal.
- To examine the optimal capital structure.
- To suggest the ways to increase profitability through adapting better strategic framework of capital structure.

RESEARCH HYPOTHESIS

A quantitative statement about population parameter is called hypothesis. In other words, it is an assumption that is made about population parameter and then its validity is tested. It may or may not be found valid in verification. The main goal of testing hypothesis is to test the characteristics of hypothesized population parameter based on sample information to find whether there exists significant relationship between the dependent and independent variables.

First hypothesis

H0: There is no significant relationship between capital structure and profitability of commercial banks.

H1: There is significant relationship between capital structure and profitability of commercial banks.

Second hypothesis

H0: There is no significant influence of capital structure on profitability of commercial banks.

H1: There is significant influence of capital structure on profitability of commercial banks.

RESEARCH METHODOLOGY

Sampling

There are various types of banks working in the modern banking system in Nepal. As per the list issued by NRB as of Mid-June 2018, the modern banking sector includes 28 Commercial Banks, 33 Development Banks, 25 Finance Companies, and 63 Micro Credit Development Banks.

Out of these financial institutions, all 28 commercial banks represent the population of the study and out of these 28 commercial banks, 3 banks have been selected as sample for the study. The sampled banks include 1 joint venture bank, 1 government bank and 1 private domestic bank. The study is based on the data and information of 6 years from the FY 2013 to 2018.

The listed 28 commercial banks in NEPSE are as follows:

1. Nepal Bank Ltd. (NBL)
2. Rastriya Banijya Bank Ltd. (RBB)
3. Nabil Bank Ltd. (NABIL)
4. Nepal Investment Bank Ltd. (NIB)
5. Standard Chartered Bank Ltd. (SCB)
6. Himalayan Bank Ltd. (HBL)
7. Nepal SBI Bank Ltd. (SBI)
8. Nepal Bangladesh Bank Ltd. (NBB)
9. Everest Bank Ltd. (EBL)
10. Bank of Kathmandu Ltd. (BOKL)
11. Nepal Credit and Commerce Bank Ltd. (NCCB)
12. NIC Asia Bank Ltd. (NICA)
13. Machhapuchhre Bank Ltd. (MBL)
14. Kumari Bank Ltd. (KBL)
15. Laxmi Bank Ltd. (LBL)
16. Siddhartha Bank Ltd. (SBL)
17. Agriculture Development Bank Ltd. (ADBL)
18. Global IME Bank Ltd. (Global)
19. Citizens Bank International Ltd. (CZBIL)
20. Prime Commercial Bank Ltd. (PCBL)
21. Sunrise Bank Ltd. (SRBL)
22. NMB Bank Ltd. (NMB)
23. Prabhu Bank Ltd. (PRVU)
24. Janata Bank Nepal Ltd. (Janata)
25. Mega Bank Nepal Ltd. (MEGA)
26. Civil Bank Ltd. (CBL)
27. Century Commercial Bank Ltd. (CCBL)
28. Sanima Bank Ltd. (SANIMA)

Out of this population size, the selected sample banks are as follows:

Joint Venture Bank:

- Nepal SBI Bank Ltd. (SBI)

Government Bank:

- Nepal Bank Ltd. (NBL)

Private Domestic Bank:

- Nepal Investment Bank Ltd. (NIB)

SOURCES OF DATA

The purpose of the study is to apply suitable and scientific methodology to complete the study during the research period. For the study, the data are obtained from the secondary sources such as audited financial statements of the selected commercial banks of Nepal, from publications of NRB (Central Bank of Nepal) and from the official websites of NEPSE.

RESEARCH METHODS

The choice of capital structure is one of the most important strategic financial decisions of firms since financing decisions influence profitability and hence, firms' value. This study examines the impact of capital structure on profitability of commercial banks listed in Nepal Stock Exchange (NEPSE). For this purpose, analytical as well as descriptive research methods shall be used with the help of appropriate statistical or financial tools such as MS-Excel and SPSS to draw the conclusions and recommendations.

CONCLUSION

It will contain history of banking sector development in Nepal along with detailed account of current position of selected commercial banks with reference to Nepal SBI Bank Ltd, Nepal Bank Ltd and Nepal Investment Bank Ltd in Nepal.

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