CAPITAL STRUCTURE AND FIRM PERFORMANCE OF COMMERCIAL BANKS IN NEPAL
(WITH REFERENCE TO EBL, ADBL, NBL & SBI)

A Thesis proposal submitted

By

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CHAPTER-1
INTRODUCTION

1.1 Background of the study

Financial institutions play a crucial role in the process of economic growth and development of a country. Financial institution refers to a business concern that is mainly confined to finance for the development of the trade, commerce and industry. The trade, commerce and industry are the main factors of the economic development. Bank is a financial institution which primarily deals with borrowing and lending money. Banking is an important part of the national economy and a vehicle for the mobilization of economic, financial resources and extension of credit to the business and service enterprise.

The first commercial bank in Nepal, Nepal Bank Ltd (NBL) was established in the history of Nepal as the country entered into official financial system. After the 19 year of established of NBL, Nepal Rastra Bank (NRB) was established in the year 2013 Baishakha 14 B.S.

Rastriya Banijya and Agriculture Developing Bank Ltd were established in the year 2022 and 2024 B.S. respectively. The first privately owned commercial bank, Nabil Bank Ltd was established in the year 2041 BS. Seven more commercial banks were added in a decade after 2041 B.S. Only 4 commercial banks were established from the period of 2051 B.S to 2063 B.S. After the economic liberalization, especially after the end of maoist insurgency in the year 2063 B.S. the number of commercial banks increased rapidly in private sectors. There are 27 commercial banks operating across Nepal till the date. However, due to inadequate capital and narrow financial inclusiveness Nepal Rastra Bank has encouraged the commercial banks for merger and acquisitions. (Share Sanchar)

Success and failure of any organization or bank mainly depends upon the structure of its optimum capital structure. It determines the profit making power of the bank as well as it helps to reduce its risk to minimum level. Capital structure is the mixture of sources of funds a firm uses (debt, preference, stock and common stock). The amount of debt that a firm uses to finance its assets is called leverage. A firm with lot of debt in its capital structure is said highly levered. Capital structure can be viewed as the permanent financing the firm represents primarily by long term debt, prefer stock and common stock equity but excluding all short term credit.

Modigliani and Miller's (1958) discussion on the issue of capital structure has inspired and fascinated many researchers. Many studies theoretically and empirically investigated and explained firms' capital structure choices. Research on the determinants of capital structure was initially directed mainly to firms in the developed countries specifically in United States.

Titman and Wessels (1988) studied the theoretical determinants of capital structure attributed namely; asset structure, non-debt tax shields, growth, uniqueness, industry classification, firm size, earnings volatility and profitability were tested to see how they affect a firm's choice of debt-equity mix.

1.2 Problem Statement

Banking sector is one of the important pillars for the economic growth and development of a country as they provide capital to create businesses and industries as well as other areas. While doing so they also have to keep their capital structure in balanced and proper ratio as per guidelines of central bank. But in Nepal, there is lack of proper utilization of capital partly due to lack of proper knowledge and corporate governance and partly due to mismanagement of funds. There are still lots of cases where loans are provided without following proper guidelines, which basically has caused a lot of problems for various commercial banks in Nepal with the increase in bad debts. Thus, the matter of assisting in economic growth of the company by these banks is far away from the reality and in this context of being burden to themselves due to the large proportion of non-performing loan.

Since the capital structure of firm is determined by firm specific variables as well as external macroeconomic variable, most of the studies are based on firm specific variables. Based on the capital structure theories tax shield, assets structure, profitability, firm size, growth, risk, liquidity, industry class and product uniqueness are the firm specific key attributes which determine the capital structure. Therefore the leverage of the firm is the function of tax shield, assets structure, profitability, firm size, growth, risk, and product uniqueness (Titman and Wessels, 1988; Ozkan, 2001; Gaud et al., 2005).This present study will try to analyzes and examine the practice of capital structure in Everest Bank Ltd, Nepal SBI Bank Ltd, Agriculture Development and Nepal Bank Limited.try to analyze and answer the following research questions:

i. What is the major determinants of capital structure and firm performance of the sample banks?

ii. What is the relationship of the capital structure and firm performance with various variables such as Return on asset, Company size, Asset tangibility, Assets growth rate and Liquidity?

1.3 Objective of the study

Primarily the study aims to analyze and interpret various aspects of capital structure and Firm Performance of Everest Bank Ltd, Nepal SBI Bank Ltd, Agriculture Development Bank and Nepal Bank Ltd. To be specific the objectives of the study are as follows:

i. To analyze the capital structure and performance of the sample banks.

ii. To analyze the relationship of the capital structure and firm performance with various variables such as Return on asset, Company size, Asset tangibility, Assets growth rate and Liquidity.

1.4 Conceptual framework

The theoretical framework of study is depicting the trend of capital structure of commercial banks and finds out how they generate the fund. The model used in this study assumes that capital structure (total debt to total assets and total debt to total equity depends on different bank specific variables. as dependent variable). This framework indicates capital structure Independent variables are size of a bank, return asset growth rate, tangibility, Return on asset, liquidity and profitability.

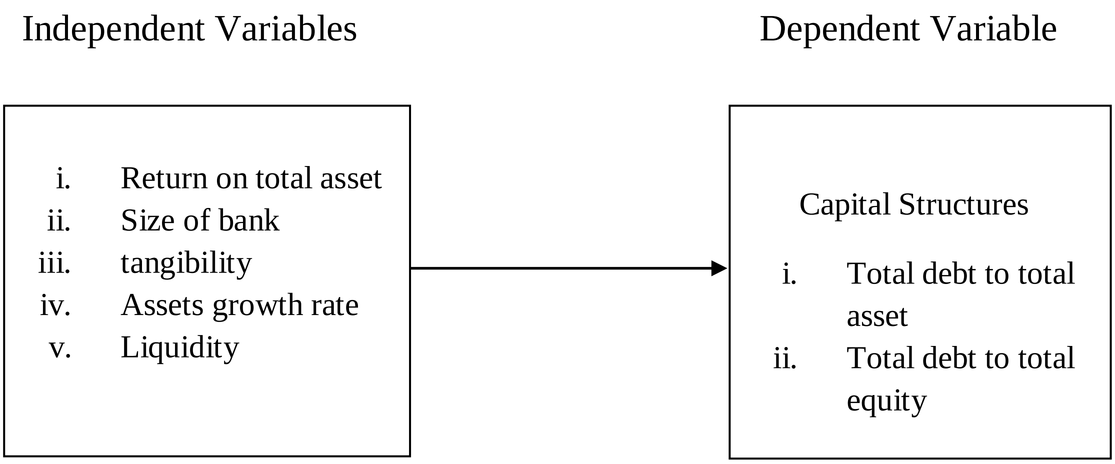

Figure: conceptual Framework

1.5 Rationale of the study

This study is about the capital structure and firm performance of commercial banks in Nepal which will be about Everest Bank Ltd, Nepal SBI Bank Ltd, Agriculture Development Bank Ltd and Nepal Bank Ltd. The study will be done with the help of performance of these four banks on the basis of secondary data over last five fiscal years. Capital structure refers to the way a firm chooses to finance its assets and investments through some combination of equity, debt, or internal funds. The capital structure of a concern depends upon a large number of factors such as size of a bank, return asset growth rate, tangibility, Return on asset, liquidity and profitability, the idea of retaining control, flexibility of capital structure requirements of investors, cost of floatation of new securities, timing of issue, corporate tax rate and the legal requirements. It is not possible to rank them because all such factors are important and the influence of individual factors of a firm changes over a period of time.

Hence, this thesis is about the capital structure and firm performance of commercial banks. Capital structure, itself as a field of study, has become the vital and important tool in the field of managerial decisions. This study will try to examine which factors are dominant in determining the capital structure of commercial banks. Hence, the study will be very useful to decision maker, investors, managers and future researchers.

1.6 Limitations of the study

The study has been prepared by the help of the financial reports and publications of the bank. The thesis has been initiated with view of tracing out different aspect of capital structure and banks performance of the bank and the calculation. As the study is more objective and is made for the fulfillment of academic requirement it possesses numbers of limitations. Some specific limitations are as follows:

i. The research work made on the basis of latest five years' data from fiscal year 2015/2016 to 2019/2020.
ii. Simple statistical and financial tools are used for the analysis.
iii. Study is made mainly on the basis of secondary data only.
iv. The usage of transaction period of the selected banks has been determined by the specific nature and availability of data.
v. Out of total 27 commercial bank in Nepal the present study deals with only selected banks (EBL, ADBL, NBL and NSBI).
vi. The other limitations are time constraints.

1.7 Organization of the study

This study will have five chapters. Each denotes the specific aspects of the study.

Chapter – 1: Introduction

It includes general background of the study, introduction of the organization, statement of the problem, objective of the study, significance of the study, limitations of the study and organization of the study.

Chapter – 2: Review of Literature

This chapter will comprise conceptual framework, review of related literature like books, dissertation, articles, journals, report and magazines etc. At last research gap is also mentioned in this chapter.

Chapter – 3: Research Methodology

This chapter deals with research methodology to be adopted for the study to satisfy the objectives of the study. It consists of research design, sample and population, sources of data, data collection procedure, methods and tools of data analysis.

Chapter – 4: Presentation and Analysis of Data

This chapter is most important and plays vital role in this study. This chapter deals with presentation, analysis and interpretation of data. These collection data will be analyzed by the help of various statistical and financial tools and techniques. It also includes major finding of the study.

Chapter – 5: Summary, Conclusion and Recommendations

This chapter summarizes the overall picture of the study, draws conclusions, offer suggestions and recommendations for improvement in the future.

CHAPTER – 2
REVIEW OF LITERATURE

This chapter basically seeks to review various books, articles, journals, theories and previous thesises as well as various studies to the concept of capital structure and more basically determinants capital structure management of commercial banks in order to fulfill the objective of this thesis. The purpose of literature review is to develop some expertise in one's area to see what new contribution can be made and to review some idea for developing design.

Methodologically, most previous studies used conventional regression estimates in their analysis of determinants of capital structure. Conventional regression analysis has been criticized for failing to recognize and mitigate measurement errors and other econometric problems that arise in studies involving estimation of latent variables (Titman and Wessels, 1988)

2.1 Conceptual Review

This sub-chapter is basically related to reviewing various books in order to get the conceptual framework of this thesis.

Meaning and Capital Structure and Firm Performance

The concept of capital structure can be defined as in the proportional relation between a firm’s debt capital and equity capital. Firms use capital structure usually to fund their business and expand. This decision is vital for a firm as it has a direct influence on the risk and return of a firm. The scholars around the world heave conceptualized capital structure in different contexts and thus in different ways. Van Horne and Wachowicz (2008) stated that it is a combination of a firm’s preferred share capital, equity capital and debt capital. Therefore, it could be said that, traditionally, capital structure has been conceptualized as a combination of long-term debt capital and equity capital, and thus ignored short-term debt capital. In the present study, besides these components, we incorporate short-term debt capital as a component of capital structure.

Capital Structure Theories

1) Trade off theory
2) Pecking order theory
3) Agency costs theory

Shibru et al. (2015) observed that profitability, bank size, tangibility and liquidity are important determinants of capital structure of banks in Ethiopia and indicate that growth and risk of banks are unrelated to banks’ capital structure. In general, a firm can choose among many alternatives capital structures.

2.2 Review of related studies

Ali, (2011) had studied "Capital Structure Theories: Empirical Evidence from Commercial Banks of Pakistan." He found that Banking sector of Pakistan offer a number of financial facilities to corporate and individual users. Along with its number of financial products and services banking sectors of Pakistan is often considered as the backbone of the economy. He suggested that mainly two directions can be explored within future research. He suggested that mainly two directions can be attributed on the financial and nonfinancial industries in the economic segment of Pakistan.

Fisseha, (2010) in thesis titled "Determinants of Capital Structure: Evidence from Commercial Banks in Ethiopia" approached the issues of capital structure by evidencing commercial banks in Ethiopia to uncover the firm level determinant factors of capital structure. To discover what determines capital structure, six firm level explanatory variables (Profitability, Tangibility, Size, Growth, Age and Tax-Shield) were selected and regressed against the appropriate capital structure measure (Debt to Equity Ratio).

Khan, (2020) in their research paper on the topic "Determinants of Capital Structure of Banks: Evidence from the Kingdom of Saudi Arabia" investigates the most important factors that affect the capital structure of commercials banks in the Kingdom of Saudi Arabia. The findings of this study suggest that banks in Saudi Arabia are highly leveraged, endorsing the fact that the nature of banks' business is different from non-banking firms. Earning volatility, growth and bank size show positive and significant relation with book leverage. Profitability and Tangibility are negatively related to the book leveraged.

Timilsina, (2020) in this article, entitled "Determinants of Capital Structure in Nepalese Commercial Banks" examines the determinants of capital structure in Nepalese commercial banks. His study is based on secondary data of 16 commercial banks with 112 observations for the period 2011/12 to 2017/18.The total debt to total assets and total debt to total equity were selected as dependent variables while return on assets, bank size, assets tangibility, assets growth and liquidity are the independent variables. The data were collected from annual reports of concerned sample bank. The Pearson's correlation coefficients and regression models are estimated to test the significance and impact of bank specific factors on the capital structure of Nepalese commercial banks. The result shows that banks size and assets tangibility are positively correlated with total debt to total assets whereas return on assets, assets growth and liquidity are negatively correlated with total debt to total assets.

2.3 Research gap

Research gap refers to the gap between previous research and this research. There are a few studies done in relation to determinants of capital structure distinctly studied by different researchers. The research gap among the previous studies and this current study lies firstly in fiscal years, sample banks and variables.

CHAPTER – 3

RESEARCH METHODOLOGY

Research Methodology is the way to solve the research problem systematically. The entire process by which we attempt to solve problems is called research. While methodology is the method used to list the hypothesis. So, Research Methodology is the process of investigation with a series of well thought activities in gathering, recording, analyzing and interpreting the data with the purpose of finding answer to the problem.

3.1 Research design

The word "Research" is derived from French word "Researcher" which means seek again. Therefore, in this thesis, research is to seek and compare the concern banks for the case study. The research designed as per objectives of the study. To fulfill the objectives of the study certain research design is essential. To fulfill the objectives of the study, descriptive and convince research design will be used.

3.2 Population, sample and Sampling Procedure

At present, there are 27 commercial banks operating in Nepal. They constitute the population sample. Among them, only four commercial banks are selected namely; Everest Bank Ltd, Nepal SBI Bank, Agriculture Development Bank Ltd and Nepal Bank Ltd. are selected for the study of Financial Analysis. Five years data are taken to conduct the study from 2015/16 to 2019/20.

3.3 Nature and Source of Data

Data is very reliable and effective source for research. This study mainly depends on the use of secondary data that consists of annual reports of the concerned bank. Besides the annual reports various other sources of data will be used for the purpose of the study plan documents, newspaper, magazine, economic journals, NRB reports etc.

3.4 Data collection procedure

This study well be based on the secondary data. Data & information are collected from Annual report, Balance Sheet of the sample banks and regulating authorities like NRB, security exchange board, etc. Similarly, the financial ratios are also used for the analysis and interpretation of the capital structure management of selected sample banks and 5 years data will be collected.

3.5 Necessary of tools and techniques for the study

The major tools that will be used in this study for the analysis of the data will be the Financial Tools and Statistical Tools.

a) Financial Tools

Financial tools help to show the mathematical relationship between two accounting items. Ratio analysis is the only tools that can collect the financial performance and status of a firm with the other firms. This study will contain the following ratios:

Ratio analysis

Dependent variables

TDA = Total debt to assets defined as total debt divided by total assets

TDE = total debt to equity defined as total debt divided by total equity

Independent variables

ROA = Return on total assets defined as net profit to total assets

FS = Firm size defined as natural logarithm of total assets in billion rupees

TNG= tangibility defined as net fixed assets divided by total assets in percentage

GRWT = Assets growth rate defined as the percentage of assets of current year minus assets of previous year divided by assets of current year.

LIQ = Liquidity defined as a ratio of current assets to current liabilities

b) Statistical Tools

Arithmetic mean:

The arithmetic mean is often known simply as the mean. It is an average, a measure of the centre of a set of data. The arithmetic mean is calculated by;

Mathematically, (Gupta; 1992:238)

Arithmetic Mean (A.M) is given by, $\overline{X} = \sum \frac{X}{n}$

Where,

$\overline{X}$ = Arithmetic Mean

$\sum$X = Sum of all the values of the variables X.

N = Number of observations

Standard Deviation

Standard Deviation, σ = $\sqrt{\frac{(X_1 - \overline{X}_1)^2}{N_1}}$

Where,

X = Variables

N = Number of variables

$\overline{X}$ = Expected rate of return or average rate of return.

Karl Pearson's Correlation Coefficient

r = $\frac{\sum XY}{\sqrt{\sum X^2 - \sum Y^2}}$

Where,

r = coefficient of correlation between X and Y (i.e. r_{xy})

x = X - $\overline{X}$ and y = Y - $\overline{Y}$

∑xy = summation of multiple of mean deviation of variables X and Y.

∑x = summation of mean deviation square of variable X

∑y = summation of mean deviation square of variable Y

Multiple Linear Regression:

Y = a + $b1x1$+$b2x2$+$btxt$+u

Where Y= the variable that are trying to predict (dependent variable) x = the variable that are using to predict Y (Independent variable) a= the intercept b=slope u= the regression residual.

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