Capital structure – determinants and trends in banking sector

Finance

The theory of capital structure is an important reference theory in any enterprise's financing policy. The capital structure includes mixture of debt and equity financing and finding an optimal capital structure is one of the most important and complex issues. The contribution of the banking sector in any economy is so immense that it attracts much attention from governmental regulatory authorities and international institutions. Most bank capital especially during start up come from combinations of various debt and equity proportion. This is obtained from shareholders to finance the company's needs and balance their leverage which signifies a good standing of the bank. Debts can be acquired in the form of bonds and long term credit while equity can be acquired through the participation of stakeholders or common stocks and retained earnings.

The study is an attempt at examining the usage of the capital structure theories in practice as well as analyzing the determinants of capital structure size, risk-return trade-off, growth rate, earning rate, debt servicing capacity, & degree of leverage in the banking sector. It also tries to address issues that pose a challenge while planning the capital structure of the banks. The capital structure and the quantum of capital held by the bank indicate the ability to the function of credit creation, which is the prime activity of any Bank.

There are three major considerations, viz, risk, cost of capital and control of the existing shareholders, which help the finance manager in determining the proportion in which he can raise funds from various sources. This project is aims to explore ways to design the capital structure of the business undertaking in such a manner that the risk and cost are minimum while the control is least diluted.

YES Bank is one of the fastest growing Indian private sector bank with a total business size of over Rupees `800, 000 million. The bank provides a full gamut of products and services in the field of corporate and institutional banking, corporate finance, financial markets, investment banking, business and transaction banking, retail and wealth management to its client from across the country. This project aims to study the capital structure of YES bank which has contributed to its exponential growth.

The title of the PhD. Thesis

The title of the thesis is ‘ Capital Structure - Trends, Determinants & Issues in India with reference to banking sector: A case study of YES Bank’.

The statement of problem

The performance of the banks is affected by the investment decision. What percentage of the capital should be debt and what percentage should be equity so as to maximize profitability of the bank given that each source of finance has a cost benefit attach to it, is a major managerial decision. The difficulties associated with designing an optimum capital structure policies to enhance profitability is the reason why this study sought to examine how capital structure affect banks’ performance with reference to YES bank.

The scope of the research study

The study focuses on the effect of capital structure on the performance of the banking sector. The study will cover a span of five years from 2007 to 2012

The objectives of the study

The objective of the study is to analyze the capital structure of banks. The project also aims to assess the capital structure and the changes in the debt-equity mix, determine the long-term profitability and also provide suitable suggestions for framing effective capital according to the requirement of the company.

Research Questions

For this research work, the following questions would serve as a guide identifying the effect of capital structure on banks performance:

Question 1:- To what extent is the profitability of banks influenced by total debt?

Question 2:-To what extent is the profitability of banks influenced by short-term ratio?

The Hypothesis

The hypotheses to be tested in order to provide answers to the questions stated above are stated in null form are as follows:

1. Profitability of banks is not significantly influenced by total debt ratio.

2. Profitability of banks is not significantly influenced by short-term debt ratio.

Literary Review

Definition of Capital structure and its components

The term capital structure refers to the percentage of capital (money) at work in a business by type. There are two forms of capital: equity capital and debt capital. Each has its own benefits and drawbacks and a substantial part of wise corporate stewardship and management is attempting to find the perfect capital structure in terms of risk and reward payoff for shareholders. A firm’s capital structure implies the proportion of debt and equity in the total capital structure of the firm. The capital structure of a firm does not include short-term credit, but means the composite of a firm’s long-term funds obtained from various sources. Therefore, a firm’s capital structure is described as the capital mix of both equity and debt capital in financing its assets. However, whether or not an optimal capital structure exists is one of the most important and complex issues in corporate finance.

Components of a Firm’s Capital Structure

The various components of a firm’s capital structure according to may be classified into equity capital, preference capital and long-term loan (debt) capital.

Equity Capital

Equity capital can be defined as including share-capital, share premium, reserves and surpluses (retained earnings). Typically, equity capital consists of two types which include: contributed capital, which is the money that was originally invested in the business in exchange for shares of stock or ownership and retained earnings, which represents profits from past years that have been kept by the company and used to strengthen the Balance Sheet or fund growth, acquisitions, or expansion.