Impact of Capital Structure on Bank Performance: An Evidence from Nigeria

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ABSTRACT

This study investigated the impact of capital structure on the performance of Nigerian Banks. Specifically the study examined how capital structure measured in terms of ratio of long-term debt to total asset, long term debt to total equity and total debt to total equity, influence performance of selected commercial Banks, as measured in terms of return on asset and earnings per share. Data were pooled from five random selected commercial banks including Access Bank Plc, Diamond Bank Plc, First Bank Plc, Guaranty Trust Bank, and First City Monument Bank, over a period of ten (10) years spanning from 2007 to 2016. Panel based estimation techniques such as pooled OLS, fixed effect OLS and random effect GLS regression were employed in the study, alongside post estimation test such as restricted F-test, and Hausman test. Result revealed that long-term debt to total asset ratio exerts insignificant positive impact on return on asset .0206427(p=0.284 > 0.05) and earnings per share 81.27549(p=0.438 > 0.05). Long-term debt to total equity ratio exerts insignificant negative impact on return on asset -.0123297(p=0.209 > 0.05), and earnings per share -24.21723(p=0.648 > 0.05). Total debt to total equity ratio exert insignificant negative impact on return on asset -0.0002932(p=0.570 > 0.05) while its impact on earnings per share is positive and insignificant 2.102547(p=0.456 > 0.05). This study concluded that the contribution of capital structure to performance of commercial banks in Nigeria is not significant. Also the study reflects that increase in debt finance at the expense of equity finance could be detrimental to the improvement of commercial banks performance especially in terms of return on asset and earnings per share. Hence Commercial Banks should ensure to balance between debt and equity finance, as any attempt to increase debt finance at the expense of equity finance could impede performance both in terms of return on asset and earnings per share. However, in addition to maintaining balance in the structural framework of finance mix, commercial Banks should give credence to other corporate issues that dictate the pace of performance of players in the banking industry given the insignificant impact of capital structure (as measured in terms of ratio of long term debt to total asset, total equity) on performance of commercial banks sampled in the study.

Keywords

Capital structure, Bank's Performance, Evidence, Nigeria

1.0 INTRODUCTION

Muhammed; Amman and Muhammed (2013) sees capital structure to consist of debt and equity used to finance the firm also the ability of the organization to carry out their stakeholders need is closely related to the capital structure. Capital structure in financial terms means the way a film finances his assets across the blend of debt, equity or hybrid securities, (SAAD, 2010). The concept behind capital Structure is the benefits of Financial Leverage which are related with the tax shield because interest on debt financing saves the tax on earnings. Capital structure plays a vital role in a firm's financial performance because the relation proportion of various sources of funds used in a business is termed as financial structure its part of the financial structure and it refers to the proportion of the various long term sources of financing. The capital structure is a combination of long –term debt, preferred stock and common equity. And if the capital structure is at optimal level it gives significant positive impacts on firms financial performance otherwise the impact maybe negative. The proportion of debt to equity of a firm is a strategic choice of corporate managers. Capital structure decision is a vital one since the profitability of an enterprise is directly is directly affected by such decision. Hence, proper Care and attention needs to be given while determining capital structure decision. In the statement of

affairs of an enterprise, the overall position of the enterprise regarding all kinds of assets, liabilities are shown and shown and capital structure is a vital part of that statement. A cautious attention has to be paid as far as the optimum capital structure is concerned with unplanned capital structure, companies may fail to economize the use of their funds.

Consequently, it is being increasingly realized that a company should plan its capital structure to maximize the use of funds and to be able to adapt more easily to the changing conditions (Pandey, 2009).The relationship between capital structure and profitability is one that has received considerable attention in the finance literature. Nonetheless in the context of banking industry, the subject has received a limited research attention. The study regarding the effects of capital structure on profitability will help to know the potential problems in performance and capital structure. The modern industrial firm must conduct its business in a highly complex and competitive business environment. Therefore these research findings will be beneficial in selecting the capital structure to achieve the optimum level of firm's profitability.

The study uses different measure of financial performance and financial structure. The basic objective of this study is to explain the impact of capital structure on banks' financial performance. As many authors explain the same relationship in their study therefore this study adopted the same relationship in the Nigeria context. The study incorporated three proxies for bank financial performance these are return on assets and earnings per share, these measures of bank financial performance were also used by Muhammad, Ammar and Muhammad (2013). These three measures of bank financial performance were applied on bank sectors of Pakistan. For banks capital structure which is the independent variable used, total debt to total equity, long term debt to total equity and short term debt to total equity, this was used by (Madiha and Muhammad, 2016). Premise on this background statement this paper set out to analyze the impact of capital structure (measured in terms of total term debt to total equity, long term debt to total equity ratio, total debt to total equity ratio) on banks performance measured in terms of return on asset and earnings per share.

2.0 LITERATURE REVIEW

2.1 Concept of Capital Structure

Capital structure is referred by Pandey (2009) as the way in which firms finances itself through debts, equity and securities. It is the composition of debt and equity that is required for a firm to finance its assets. The capital structure of a firm is very important since it is related to the ability of the firm to meet the needs of its stakeholders. The Board of Directors or the financial manager of a company should endeavor to develop a capital structure that would be beneficial to the equity shareholders in particular and to the other groups such as employees, customers, creditors and the society in general.

2.2 Empirical Review

Mubeen; Muhammad; Syeda and Muhammad (2014) examined 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 reversions models were used to evaluate the relationship between capital structure and bank performance. Performance was measured by return on Assets, return on equity and earning per share. Determinants of capital structure contained 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.

Madihr and Muhammad (2016) attempted to test the significance of the impact of capital structure on financial performance of banks listed in Karachi stock Exchange. The study is explanatory in nature and deductive approach was adopted. The study incorporated financial performance variables as dependent and Capital structure (Financial Structure) as independent The dependent variables are spread ratio, return on assets and earnings per share and independent variables are total debt to total equity, long-term debt to total equity and short term debt to total equity. Furthermore, the study incorporated data for five years from 2009 to 2013. The results showed that capital structure is negatively related with banks performance, in Pakistan. All null hypotheses could not be accepted at level of significance 0.01 therefore all estimators were significantly related with performance. The study specially explained that in the researches of Capital structure the financial and non-financial sector cannot be combined because the relationships are opposite.

Tannin (2013) assessed the impact of capital structure on performance of Jordanian Bank. The annual financial statements of 12 commercial banks listed on Amman stock exchange were used for this study which covers a period

of time (5) years from 2007 -2011.Multiple regression was applied in performance indicators such as Net profit (NP), Return on capital Employed (ROCE), Return on Equity (ROE) and Net interest Margin (NIM) as well as total debt to total funds (TDTF) and total debt to total equity (TDTE) as capital structure variables. Multiple regressions models were applied to estimate the relationship between capital structure and banking performance. The results showed that bank performance which is measured by Net profit, Return on capital employed and Net interest margin is to be significantly and positively associated with total debt; while total debt is found to be insignificant in determining returns or equity in the banking industry of Jordan.

Aremu; Ekpo; Mustapha and Adedoyin (2013) considered capital as the corner stone of a bank's financial strength since it supports bank operations by providing a buffer to absorb unanticipated losses from its activities and in the event of problems, enabling the bank to continue to operate in a sound and viable manner while the problems, are addressed or resolved. The objective of the study is to examine the relationship between the level of leverage ratios with ''Size''; Divided payout'', Profitability'', ''Tangibility'', Liquidity'', Growth'' and ''Tax Change''; with reference to the capital structure models and theories, and to identify leverage ratios which indicates the most pertinent factor motivating the capital structure choice in Nigerian banking industry between 2016 and 2010. The study made use of the econometric procedure in estimating the relationship between banks capital structure and its key determinants. The pooled ordinary least structure (Pooled OLS) techniques were employed in obtaining the numerical estimates of the coefficients in different equations.

Anaifo and Appianhere (2017) investigated the impact of capital structure on the profitability of banks in Africa. Using dynamic panel regression robust analysis and data from 37 countries in South Africa, the study employed the debt Ratio (DR) as a measure of capital structure; whereas banks Profitability was measured using Risk Adjusted Return on Asset (RAROA), Risk Adjusted Return on Equity (RAROE) and Net interest Margin (NIM). The findings suggested that banks capital structure is a driver of profitability. Other variables that significantly were banks profitability are size, tangible asset, growth, taxes and interest rate.

Niresh (2012) investigated the impact of capital structure on profitability of ten listed Srilankan banks over the past 8 years from the period of year 2007 to 2009. Regression analysis was carried out to test the variables. Based on the findings of the study, there are a few key points that can be used to conclude the study. It is very important that the total debt is the determining factor of profitability in the banking industry of Srilanka. The outcomes of the study may guide banks, loan creditors and policy planners to formulated better publicity decisions as far as the capital structure is concerned.

2.3 Concept of Performance

The Pecking order theory of capital structure seems to suggest that there is a negative relationship between firm's capital structure and performance Murinde, Agung and Mullineux (2004) observed that retained earnings are the principal source of finance. According to Titman and Weasels (1988) and Barton, need and Wessel (1988) and Barton, Ned and Sundarain (1989) firms that have a higher profit would maintain a low debt ratio since they are able to generate those funds internally ''all other things being equals ''. Evidence from empirical studies seem to support the Pecking order theory other studies that have found a negative relationship between bank performance and capital structure which include Friend and Lang (1988) Baronial (1989), Caesar and HoImes (2003), Esperanca; Ana and Muhammed (2003) and Hall, Hutchinson and Michaels (2004). Some researchers such as Bettis and Hall (1982) Demsetz and Lehn (1985), Habib and Victor (1991), Zeitun and Tian (2007) among others, used return on equity (ROE) and return on asset as proxies for firms' performance in their Studies.

However, this study adjusted the conventional performance measure used by other empirical Studies and adopts the work of Muhammad, Farrukli and Rais (2016) they used return in capital employed (ROCE), return on capital Asset (ROA) and Earnings per share as a measure for bank performance. Their measures of performance are the dependent variables An adjust on that independent variable was made to be total debt to equity , total debt to total asset, their short term debt to total equity and short debt to assets

3.0 METHODOLOGY

Model Specification

This study estimated two panel based models. The study measured Bank's performance in terms of Return on Asset (ROA)as calculated by the ratio of net income to total asset, and Earnings per Share (EPS)reported on financial statement of banks as the fraction of earnings for the year

that is attributed to a unit of share, while capital structure was measured in terms of ratio of Long-term Debt to Total Asset (LTD/TA), ratio of Long Term Debt to Total Equity (LTD/TE), as well as ratio of Total Debt to Total Asset (TD/TE). The two models were controlled by firms size (FZ) as measured in terms of natural log of total asset. Linear representation of the two models estimated in the study is given below:

Model 1:

$$ROA_{it} = \delta_0 + \delta_1 {}^{LTD}/_{TA_{it}} + \delta_2 {}^{LTD}/_{TE_{it}} + \delta_3 {}^{TD}/_{TE_{it}} + \delta_4 FZ_{it} + \mu_{1t} - - - - - -(i)$$

Model 2:

$$EPS_{it} = \beta_0 + \beta_1 {}^{LTD}/_{TA_{it}} + \beta_2 {}^{LTD}/_{TE_{it}} + \beta_3 {}^{TD}/_{TE_{it}} + \beta_4 FZ_{it} + \mu_{2t} - - - - - -(ii)$$

Where:

ROA=Return on Asset (ratio)

EPS=Earnings per Share (kobo)

LTD/TA= Long term debt to total asset ratio

LTD/TE=Long term debt to total equity ratio

TD/TE= total debt to total equity ratio

FZ= Firm's Size (natural log of total asset)

μ_{it} = Stochastic Error Term,

Source(s) of Data and Method of Analysis

Data used in the study were sourced from the annual report of 5 randomly selected money deposit banks in Nigeria. Banks sampled in the study included Access Bank Plc, Diamond Bank Plc, First Bank Plc, Guaranty Trust Bank, and First City Monument Bank. The study covered a period of ten (10) years (2007-2016). Data collated were analyzed using correlation analysis, pooled OLS estimation, fixed effect estimation and random effect estimation, followed by post estimation test such as restricted R-square test and Hausman test.

4.0 DATA ANALYSIS AND INTERPRETATION

Correlation Analysis

Table 1: Correlation matrix

	ROA	EPS	LTD/TA	LTD/TE	TD/TE	FZ
ROA	1.0000					
EPS	0.6110	1.0000				
LTD/TA	0.0642	0.0713	1.0000			
LTD/TE	-0.0260	0.3824	0.4327	1.0000		
TD/TE	-0.1857	0.1322	0.0713	0.3784	1.0000	
FZ	0.1538	0.5559	0.0621	0.1908	0.0289	1.0000

Source: *Authors' Computation, (2018)*

Result presented in table 1 revealed that there is positive correlation between return on asset, and explanatory variables such as ratio of long term debt to total asset, and firm size, but negative correlation with ratio of long term debt to total equity, as well as ratio of total debt to total equity. This implies that return on asset moves predominantly in the same direction with ratio of long term debt to total asset and firms size, but in opposite direction with ratio of long term debt to total equity. On the other hand result showed that there is positive correlation between earnings per share and all the explanatory variables, thus reflecting that earnings per share move in the same direction with ratio of long term debt to total asset, long term debt to total equity, total debt to total equity and firms size. For set of explanatory variables used in the study correlation coefficient stood at 0.4327,0.0713, 0.0621, 0.3784, 0.1908, 0.0289 for LTD/TA and LTD/TE, LTD/TA and TD/TE, LTD/TA and FZ, LTD/TE and TD/TE, LTD/TE and FZ. The magnitude of the correlation between explanatory variables used in the study established that the is low possibility of multi-collinearity between the variables.

Table 2: Pooled OLS Estimations

	ROA		EPS	
Variables	**Coefficients**	**Probability**	**Coefficients**	**Probability**
C	.005656	0.746	-377.9643	0.001
LTD/TA	.0089548	0.643	-91.42226	0.428
LTD/TE	-.0008198	0.924	119.0015	0.024
TD/TE	-.0006711	0.234	-.0153762	0.996
FZ	.0009621	0.289	22.58153	0.000
	R-square = 0.4647 Adjusted R-square= 0.4485 F-stat=10.78 Prob (F-stat)=0.0055		R-square =0.3970 Adjusted R-square= 0.3434 F-stat=7.41 Prob(F-stat)=0.0001	

Source: *Authors' Computation, (2018)*

Estimation result presented in table 2 revealed the effect of capital structure variables (LTD/TA,LTD/TE, TD/TE) on performance of banks measured in term of return on asset and earnings per share, when heterogeneity effect across banks sampled in the study is not given consideration. Result showed that ratio of long term debt to total asset exert insignificant positive impact on return on asset.0089548 (p=0.643> 0.05), but insignificant impact on earnings per share -91.42226(p=0.428> 0.05). Ratio of long term debt to total equity exerts negative insignificant impact on return on asset -.0008198(p=0.924> 0.05), but its impact on earnings per share is positive and significant 119.0015(0.024< 0.05). Ratio of total debt to total equity exerts negative insignificant impact on both retune on asset-.0006711 (0.234> 0.05) and earnings per share -.0153762(p=0.996> 0.05). Reported R-square stood at 0.4647 and 0.3970 for the first and second models respectively, which implies that about46% and 40% of the systematic variation in return on asset and earnings per share can be explained jointly by variation in return on asset and earnings per share, when heterogeneity effect across sampled banks is not accounted for.

Table 3: Fixed effect Estimations

	ROA		EPS	
Variables	**Coefficients**	**Probability**	**Coefficients**	**Probability**
C	.0349578	0.649	-1120.94	0.010
LTD/TA	.0206427	0.284	81.27549	0.438
LTD/TE	-.0123297	0.209	-24.21723	0.648
TD/TE	-.0002932	0.570	2.102547	0.456
FZ	-.0004172	0.911	59.41181	0.005
Fixed Effect				
DIAMOND BANK	-.0105298	0.104	-46.96962	0.182
FIRST BANK	-.0068395	0.778	255.1749	0.060
GTBANK	.0168481	0.012	111.089	0.003
FCMB BANK	-.0048708	0.529	3.696345	0.930
	R-square =0.5584 Adjusted R-square=0.5332 F-stat=12.86 Prob(F-stat)=0.0026		R-square =0.6527 Adjusted R-square=0.5850 F-stat=9.63 Prob(F-stat)=0.0000	

Source: *Authors' Computation, (2018)*

Estimation result presented in table 3 revealed the effect of capital structure variables on performance, when heterogeneity effect across sampled banks is incorporated into the model as intercept term. As reported in table 3 ratio of long term debt to total asset exert insignificant positive impact on return on asset .0206427(p=0.284> 0.055), and earnings per share 81.27549(p=0.438> 0.05). Long term debt to total equity ratio exerts insignificant negative impact on return on asset -.0123297(p=0.209> 0.05), and earnings per share-24.21723(p=0.648 > 0.05). Total debt to total equity ratio exerts insignificant negative impact on return on asset -.0002932(p=0.570> 0.05), but positive insignificant impact on earnings per share 2.102547(p=0.456> 0.05).Deviation from the intercept term of the reference banks (Access bank Plc) stood at -.0105298,-.0068395,.0168481,-.0048708 and -46.96962,

255.1749,111.089, 3.696345for Diamond Bank Plc, First Bank Plc, Guaranty Trust Bank, and First City Monument Bank in the first and second model respectively. Reported R-square stood at 0.5584and 0.6527 for the two estimated models respectively, thus reflecting that when heterogeneity effect across sampled banks is incorporated into the model as intercept deviation term, the explanatory variables jointly explained about 56% and 65% of the systematic variation in return on asset and earnings per share respectively.

Table 4: Random Effect Estimation

	ROA		EPS	
Variables	**Coefficients**	**Probability**	**Coefficients**	**Probability**
C	.005656	0.744	-377.9643	0.000
LTD/TA	.0089548	0.640	-91.42226	0.424
LTD/TE	-.0008198	0.923	119.0015	0.019
TD/TE	-.0006711	0.228	-.0153762	0.996
FZ	.0009621	0.283	22.58153	0.000
	R-square = 0.5647 Wald chi2=13.11 Prob(chi2)= 0.0094		R-square = 0.6652 Wald chi2=29.63 Prob(chi2)= 0.0000	

Source: *Authors' Computation, (2018)*

Random effect estimation result presented in table 4 revealed that when heterogeneity effects across banks sampled in the study is incorporated into the error terms of the models specified in the study long term debt to equity ratio exerts insignificant positive impact on return on asset.0089548(p=0.640> 0.05), but insignificant negative impact on earnings per share-91.42226(p=0.424> 0.05). Long term debt to total equity ratio exerts negative insignificant impact on return on asset -.0008198(p=0.923> 0.05), but its impact on earnings per share is positive and significant 119.0015(p=0.019< 0.05). Total debt to total equity ratio exerts insignificant negative impact on return on asset -.0006711(p=0.228> 0.05), and earnings per share -.0153762(p=0.996> 0.05). Reported R-square stood at0.5647 and 0.6652 for model 1 and model 2 respectively, Thus showing that about 56% of the systematic variation in return on asset, can be explained by variation in all the explanatory variables, while about 67% of the systematic variation in earnings per share can be explained jointly by the explanatory variables.

Post Estimation Test:

Table 5: Restricted F Test of Heterogeneity

	F-statistics	Probability
Model 1	4.69	0.0033
Model 2	7.55	0.0001

Source: Authors' Computation, (2018)

Table 6: Hausman Test

	Chi-square stat	Probability
Model 1	98.10	0.0000
Model 2	16.60	0.0023

Source: Authors' Computation, (2018)

Give the significance of the reported f-statistics for model 1 and 2 in table 5, it stands that there is enough evidence to invalidate the restriction of pooled OLS estimation for the two models, which therefore justify the incorporation of heterogeneity effect across the sample banks in the model. Also the reported Hausman test for model 1 and 2 revealed that there is enough evidence to reject the null hypothesis that differences in the estimates of fixed and random effect estimation is not systematic. Therefore the result showed that the most consistent and efficient estimator for the investigation conducted in the study is shown by the fixed effect estimation results for model 1 and 2 presented in table 3.

Discussion

Consistent and efficient estimation result presented in table 3 revealed that long term debt to total asset ratio as a measure of capital structure exerts positive impact on performance of banks sampled in the study as measured in terms of return on asset and earnings per share. The result revealed specifically that when the ratio of long term debt to total asset increases by a unit, return on asset will increase by .0206427unit, while earnings per share will rise by about 81.27 kobo. Result showed that long term debt to total equity ratio exerts negative impact on both return on asset, and earnings per share. In clear terms, the result revealed that increase in the ratio of long term debt to total equity by a unit will engender about 0.0123297 unit decline in return on asset, and about 24 kobo decline in earnings per share for that same period. Finally the result showed that total debt to total equity ratio exert negative impact on return on asset but its impact on earnings per share is positive and insignificant. The result

showed specifically that increase in the ratio of total debt to total equity by a unit will culminate into about -.0002932 in return on asset, while such increase will lead to about 2 kobo increase in earnings per share.

5.0 CONCLUSION AND RECOMMENDATION

Based on the results of the study, it was established that performance of commercial banks is not significantly influenced by capital structure framework, both when performance is measured in terms of return on asset and earnings per share. However increase in the ratio of debt finance to total asset of banks has positive influence on performance of banks both in terms of return on asset and earnings per share, as against the established deleterious impact of long term debt to total equity ratio and total debt to total equity ratio on both return on asset and return on equity. This study thus reflects that increase in debt finance at the expense of equity finance could be detrimental to the improvement of commercial banks performance especially in terms of return on asset and return on equity. Notably, discoveries made in the study and the conclusion established therein, is in congruence with the findings/standing of previous studies such as Madihr and Muhammad (2012) and Tannin (2013).Hence, Commercial banks should ensure to balance their mix of debt and equity finance, as any attempt to increase debt finance at the expense of equity finance will be detrimental to performance both in terms of return on asset and earnings per share. However, in addition to maintaining balance in the structural framework of finance mix, commercial Banks should give credence to other corporate issues that dictate the pace of performance of players in the banking industry given the insignificance impact of capital structure (as measured in terms of ratio of long term debt to total asset, total equity) on performance of commercial banks sampled in the study.

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