WWW.IJRPR.COM

International Journal of Research Publication and Reviews

Journal homepage: www.ijrpr.com ISSN 2582-7421

A Study of the Relationship Between Capital Structure and Cost Capital Among Commercial Banks in Malawi

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ABSTRACT

The essence of cost of capital on the sources of finance is a very crucial element of which commercial banks prioritize when formulating their capital structure. Capital structure decisions are among the most important and crucial decisions for any firm of business because of their effect on the performance of firms. The initial concept of Capital structure deals with the various sources of finance that the commercial banks use in order to facilitate their everyday operations in accordance with the need present.

The basis of the study was to analyze the relationship that exists between capital structure and cost of capital among commercial banks in Malawi. In order to fully attain and achieve the set objectives, the study was conducted and financial statement analysis was carefully executed. The sample of five banks was selected on the basis of the banks that are listed on the Malawi Sock exchange namely National bank, standard bank, NBS Bank, FDH Bank and First Capital Bank. The information obtained from the financial statement was analyzed using Microsoft Office; excel 2019 to obtain tables, pie charts and bar graphs from which the researchers were able conclusions, recommendations as well as highlighting the area for further study.

The analysis revealed that there is a positive relationship between capital structure and cost of capital among commercial banks in Malawi. The results conclusively explicated that an increase in capital structure will bring about a simultaneous increase in cost of capital and a decrease in capital structure will bring about a simultaneous decrease in cost of capital. The study also portrayed the benefits that commercial banks could derive from an optimal capital structure for instance: maximize companies' wealth, minimize cost of capital and retain control of the entity.

1. Introduction

This research is based on the study of the relationship between capital structure and cost of capital among commercial banks in Malawi. This chapter provides more of an overview of the components that are involved in this particular research, which could be split into seven sections for instance: the introduction, Background of study, problem statement, and research objectives, and research questions, scope of study and significance of the study.

2. Literature review

Empirical review on capital structure and profitability

I. Pakistan's Commercial Banks

Sadiq and Sher (2016) researched on capital structure's impact on profitability of listed commercial banks in Pakistan. commercial banks listed on KSE were sampled and data collected from their publications and website of Stat Bank of Pakistan from 2006 to 2012 were analyzed through regression analyses. The SPSS result obtained indicated an inverse relationship between debt & equity.

I. India's Commercial Banks

The banks in pursue of the monetary and credit policy for 2000-01, a standing technical committee of the RBI and SEBI on bank financing equities was constituted to develop operative guidelines for a transparent and stable system of banks' financing of equities and investment in shares. After the research they came up with the result that the approach to optimize the capital market returns without exposing them to undue risk arising from market volubility (shekhar, 2014). As per final guidelines the terms and conditions for financing of initial public offerings should be the same as those applicable to advances against shares to individuals. As it was recommended by the committee, within the overall exposure to sensitive sectors, the banks total exposure to capital market by the way of investments in ordinary shares, convertible debentures and units of mutual funds (other than debt funds) should not exceed 5 percent of the total outstanding advances as on 31 March of the previous year as against the earlier ceiling of 5 percent of incremental deposits of the previous year (shekhar, 2014).

Conceptual Theories

These are theories that stand as a foundation stone of capital structure and later on relate to the cost of capital. capital structure, in financial terms, means how a firm finances its assets through the combination of equity and debt. A company can only employ equity leading to an unlevered firm, whereas a mixture of equity and debt entails a levered firm while hybrid capital contain features of both debt and equity (Rajan,R.G & Zingales, 1995).Capital structure in banks usually involves the use of more debt than equity in terms of financing their operations.

2.2.1 Trade-Off Theory

According to the trade-off theory, there is a benefit associated with the use of debt financing and a cost associated with the use of debt financing. The marginal benefit of additional debt increases as debt increases, while the marginal cost increases, so a firm seeking to maximize its overall value will consider this trade-off when deciding how much debt and equity to use for financing. (Muchugia, 2013).This theory aims to explain that most firms are usually partly finance by debt and partly equity.it vividly illustrates the cost and benefit that is implicated on a firm for using debt financing. The costs associated with the use of debt are bankruptcy cost and the no bankruptcy cost for instance: staff leaving due to low pay and suppliers demanding disadvantageous payment terms.

The marginal benefit of using debt financing increases if the debt declines while on the other hand as debt increases then the marginal cost thereby increases. Due to this firm will thereby implement the trade-off theory in which it aims at having an appropriate mix between debt and equity which will be used as a source of financing.

2.2.2 Pecking Order Theory

This theory maintains that businesses adhere to a hierarchy of financing sources and prefer internal financing when available, and debt is preferred over equity if external financing is required (equity would mean issuing shares which meant 'bringing external ownership' into the company. Thus, the form of debt a firm chooses can act as a signal of its need for external finance (Muchugia, 2013).This theory states that there is a hierarchy of financing sources. The theory implicates that the firm is to use the internal sources of finance before resulting into external sources of finance. The firm is first to use internal debt to finance its operations and when that seems unprofitable then the firm is to obtain an external debt and when that is depleted then the firm can later on use equity.

According to the pecking theory the use of equity for financing is a means of last resort.

3. Methodology

The intent of this was to vividly illustrate the research methods employed in the study in order to meet the research objectives, the study will deploy quantitative techniques of which will mainly focus on the analysis of the financial statements of defined period of time. All ethical techniques and measures will be put in place in order to ensure there is reliability of information that will be able to give a true and correct picture of the research after the analysis of the relevant information. Chapter four depicts the findings and discussions of the study.

4. Results

The researcher represented the true reflection of the analyzed results that were acquired from the unprocessed data which was obtained through the analysis of the financial statements that were obtained from the secondary source mainly the internet, from the respective commercial banks website. Efficient analysis on data was to be carried out in order to provide answer for the research questions and later on to satisfy the needs of the research objectives and bring forth concrete results from such an analysis. The software package that was used to compute figures and come up with the necessary charts and graphs was Microsoft Excel.

4.1 Financial statement analysis

4.1.1 Financial statement analysis for the year 2017

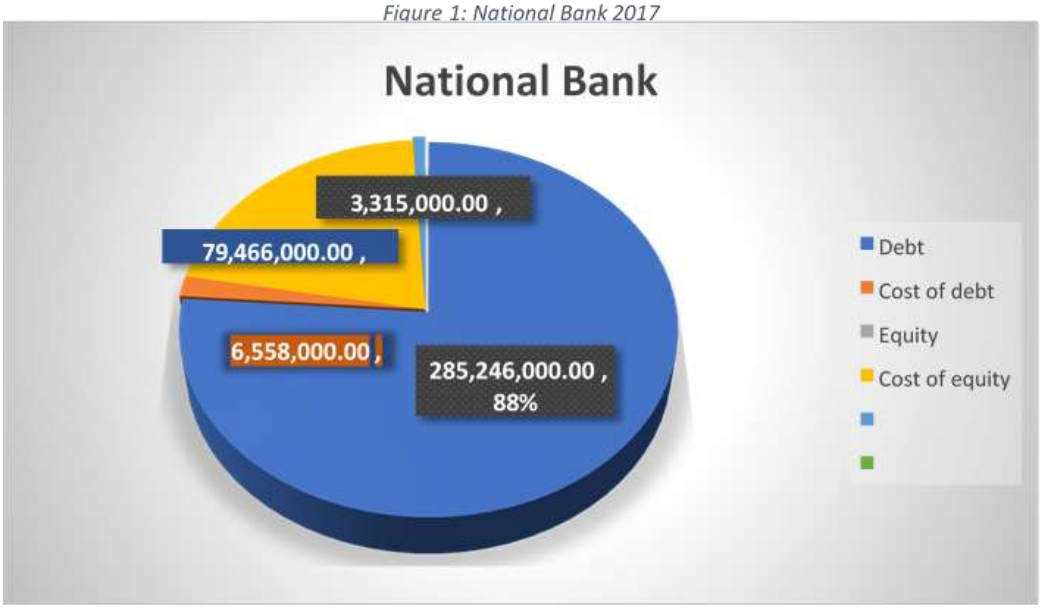
Table 1: Financial analysis for 2017

FINANCIAL STATEMENT ANALYSIS FOR THE YEAR ENDED 2017							
NAME OF BANK	**DEBT UTILSED**	**COST OF DEBT**	**% OF DEBT**	**EQUITY UTILISED**	**COST OF EQUITY**	**% OF EQUITY**	**TOTAL PERCENTAGE**
National Bank	285,246,000.00	6,558,000.00	88	79,466,000.00	3,315,000.00	12	100

Standard Bank	356,018,000.00	8,807,000.00	83	71,140,000.00	6,500,000.00	17	100
First capital	196,206,000.00	8,039,000.00	84	36,585,000.00	1,168,000.00	12	100
NBS	99,593,933.00	3,332,621.00	88	12,549,754.00		12	100
FDH	136,452,814.00	8,923,175.00	90	13,597,230.00	-	10	100

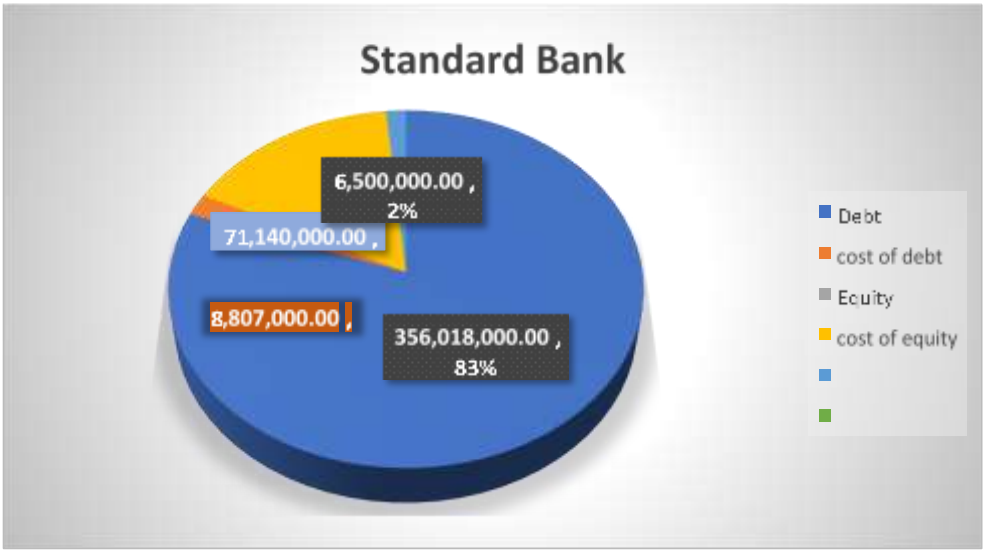
***Source**: secondary data (financial statement)*

Figure 1: National Bank 2017



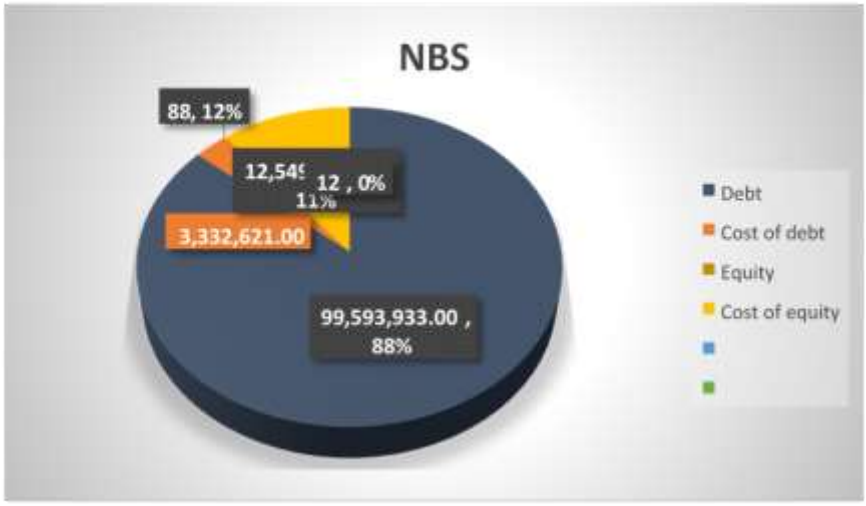
Interpretation: In the year of 2017 National bank utilized 88% of debt which amounted to MWK285, 246,000 and utilized 12% of equity which amounted to MWK 79,466,000 and the cost of debt was MWK 6,558,000 and cost of equity was MWK 3,315,000.

Figure 2: Standard Bank 2017



Interpretation: In the year of 2017 Standard bank utilized 83% of debt which amounted to MWK356, 018,000 and utilized 17% of equity which amounted to MWK 71,140,000 and the cost of debt was MWK 8,807,000 and cost of equity was MWK 6,500,000.

3: NBS 2017



Interpretation: In the year of 2017 NBS bank utilized 88% of debt which amounted to MWK99, 593,933 and utilized 12% of equity which amounted to MWK 12,594,754 and the cost of debt was MWK 3,332,621.

Findings

The researchers findings revealed that, Capital structure refers to the relationship between various long-term sources of financing such as debenture, preference share capital and equity capital including reserves and surplus (Asheesh Pandey & Madan singh, 2015) .The research work portrayed that there is a positive relationship between capital structure and cost of capital among commercial banks as overall projection of the results stated that as capital structure increases so did the cost of capital and a decline in the capital structure caused decline in the cost of capital. For instance national bank in the year of the 2017 had a capital structure of k435,934,000 and cost of capital of k12,731,000 which in the year of 2018 the value of capital structure then increased to k533,368,000 and cost of capital increased to k13,677,000 which shows a positive relationship between capital structure and cost of capital simultaneously standard bank in the year of 2017 had a capital structure of k357,721,000 and the cost of capital amounting to k6,962,000 and later on in the year of 2018 The capital structure then increased to k375,264,000 and the cost of capital to k10,395,000 which illustrates a positive relationship between capital structure and cost of capital (see 4.1.5).the same can be stated of First capital ,NBS and FDH who also had the same positive relationship between capital structure and cost of capital as an increase in the capital structure caused an increase in the cost of capital and a decrease the capital structure caused a decrease in the cost of capital .

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