



Impact of Capital Structure on Performance of Commercial Banks in Nigeria

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ABSTRACT

The study evaluated the influence of financing mix on the performance of commercial banks, and the causal link between debt-equity ratio. Data collated were analyzed using correlation analysis, pooled OLS regression analysis, fixed effect panel analysis, random effect panel analysis, granger causality analysis, as well as post estimation test such as restricted f-test of heterogeneity and Hausman test. The findings show that while debt finance exert negative and significant impact on return on asset, the debt-equity ratio has positive and significant influence on return on equity. There was neither unidirectional nor bidirectional relationship between capital structure and performance of commercial banks in Nigeria.

Keywords: Capital Structure, Commercial Banks, Nigeria

JEL Classifications: G21, G3, G32

1. INTRODUCTION

As pointed out by Pandey (2001) capital structure is a significant managerial decision because it influences the shareholder's return, risk and the market value of the firms' share. In his assertion he also pointed out that in making capital structure decisions corporate managers are expected to seek answer to question like, how does the proposed financing mix affects the shareholders' risk, return and value? Performance of a firm on the other hand, has to do with how effectively and efficiently it is able to achieve the set goals which may be financial or operational. The financial performance of a firm relates to its motive to maximize profit both to shareholders and on assets (Kester, 1986) while the operational performance concerns with growth and expansions in relations to sales and market value (Hofer and Sandberg, 1987). Aftab et al. (2012) assert that a firm's performance can be measured in terms of its profitability and market performance. Typically, profitability is measured in terms of return on the capital invested in the business or return on the revenues generated during a given period. On the other hand, market performance is measured in terms of market indicators such as share price and dividend yield ratio. Barbosa and Louri (2005) posit that the assessment of financial performance is

based on the return on investment, residual income, earnings per share, dividend yield, price/earnings ratio, growth in sales, market capitalization, among others.

Nigerian financial sector had experienced myriad of reforms in the last two decades owing to the general state of the sector which calls for exigent institutional restructuring. In the past decades the observed trend of performance of commercial banks in Nigeria has not been encouraging as can be seen from series of abnormalities and signs of stagnation in the banking sector in the 1990s which as a result the Apex bank (Central bank of Nigeria) had to revoke licenses of 31 banks between 1994 and 1998 for reasons including inadequate capitalization, insider dealings and debt overhang (Sev et al., 2014).

However the lingering problem of inability of Nigerian commercial banks management to decide on the appropriate finance mix that can gear the desired performance has hither-to called for great deal of attention and debate among scholars. Albeit most of the studies on the subject of capital structure in Nigeria concentrated majorly on investigating the determinants of capital structure, while few studies that examined the impact of capital structure on

performance of Nigerian commercial banks employed technique of multiple regression analysis and/or pooled OLS regression analysis. Previous empirical studies have always ignored such heterogeneous factors like corporate governance, decision making process, culture, etc., that may exist amongst commercial banks in Nigeria. It is against this backdrop that this study is aimed at filling the gap in the field of capital structure as it relates to performance of commercial banks by incorporating both fixed effect and random effect model to account for their cross sectional uniqueness.

The broad objective of the study is to investigate the impact of capital structure on performance of commercial banks in Nigeria. The specific objectives are to determine the influence of (1) equity financing, (2) debt financing on performance of commercial banks, and (3) to investigate the causal link between debt-equity ratio and performance of commercial banks. The apriori assumptions are that neither equity nor debt financing has positive and significant influence on commercial banks' performance. Also there is no causal relationship between debt-equity ratio and performance of commercial banks.

2. LITERATURE REVIEW

2.1. Conceptual Framework

Capital structure in financial term means the way a firm finances their assets through the combination of equity, debt, or hybrid securities (Saad, 2010). Determinants of capital structure include firm's size, asset structure, profitability, growth prospects, tax rates, industrial classification as agreed by Titman and Wessels (1988), Harris and Raviv (1991), Bauer (2004), (Marsh, 1982), Myers (1977), MacKie-Mason (1990), Pesando and Shum (1999) and Graham' (1999), Hsia (1981), Huang and Song (2002), Kale et al. (1991), Harris and Raviv (1991). (Marsh, 1982) and Myers (1977) submit that firms with high future growth opportunities should use more equity in their financing because a higher leveraged company is likely to pass up more profitable investment opportunities. Titman and Wessels (1988), Harris and Raviv (1991) state that the degree to which assets of a firm are tangible should result to greater liquidation value for the firm. Kale et al. (1991) submit that the risk of bankruptcy is said to be among others, a major determinant of firm's capital structure. Firm's volatility is taken as a probability of its bankruptcy (Bauer, 2004) and therefore a proxy for firm's risk. Bauer (2004) states that from the agency cost theory view point, firms with a more profit should have higher leverage for income they shield from taxes. It holds the view that more profit firms should make use of more debts purposely to serve as a disciplinary measure for the managers. A company having a, higher tax is to use more of debt and therefore to employ more of leverage because of more income it shields from taxes. There are many empirical studies conducted that explored the impact of taxes on the firm's financing policies mostly on, the industrialized countries with most focusing on the policy of tax such as MacKie-Mason (1990), Pesando and Shum (1999) and Graham' (1999). Mackie-Mason (1990) as stated by Mackie-Mason (1990) concludes that changes-in the marginal tax rate for any firm should affect its choices between equity and debt. The industry to which a firm belongs is said to be significantly related to its, debt ratio. Some classes of industry are reported to

have low leverage such as drugs, instruments, electronics, and food industries while paper, textile mill, products, steel, airlines, and cement industries have large leverage (Harris and Raviv, 1991).

The concept of performance is a controversial issue in the finance strategy of most corporate organizations due to its multidimensional meanings (Tian and Zeitun 2007). Performance measure could be in form of financial or operational performances such as maximizing profit on assets, profit maximization, and maximizing shareholders' benefits. These are at the core of the firm's effectiveness (Kester, 1986). Operational performance such as growth in sales and growth in market share etc., provide a broad definition of performance as they focus on the factors that ultimately lead to financial performance (Hofer and Sandberg, 1987). From the foregoing, capital structure is largely represented by debt, equity and debt-equity ratio while organizational performance is largely evidenced by the firm's profitability (return on the capital invested).

2.2. Theoretical Framework

Modigliani and Miller (1958) propounded a theory which states that the market value of a firm is determined by its earning power and the risk of its underlying assets is independent of the way it chooses to finance its investment or distribute dividends. In clear term the theory posited that a firm's total market value is independent of its capital structure. The M and M proposition is based on the assumptions that financial markets are perfect where individuals and firms are price-takers, frictionless, no transaction costs, all agents are rational, all agents have the same information, a firm's cash flows do not depend on its financial policy (or bankruptcy costs) and no taxes. Albeit in the real world, there are taxes, transaction costs, and bankruptcy costs, differences in borrowing costs, information asymmetries and effects of debt on earnings. Therefore to understand how the M and M proposition works after factoring in corporate taxes, many scholars had queried the M-M proposition.

The trade-off theory assumes that there are benefits to leverage within a capital structure up until the optimal capital structure is reached. The theory recognizes the tax benefit from interest payments - that is because interest paid on debt is tax deductible, while issuing bonds effectively reduces a company's tax liability. The theory emphasized that as the proportion of debt in the company's capital structure increases, its return on equity to shareholders increases in a linear fashion. The existence of higher debt levels makes investing in the company more risky, so shareholders demand a higher risk premium on the company's stock. The theory refers to the idea that a company chooses how much debt finance and how much equity finance to use by balancing the costs and benefits. It identifies the benefit of financing with debt, the tax benefit of debt, as well as a cost of financing with debt, financial distress including bankruptcy costs of debt. The static trade off theory of capital structure predicts that firms will choose their mix of debt and equity financing to balance the cost and benefits of debt. It should however be realized that a company cannot continuously minimize its overall cost of capital by employing debt. Therefore it would not be advantageous to employ debt further, so there is a combination of debt and equity which minimizes the firm's average cost of capital and maximizes the market value per share.

Pecking order theory was first suggested by Donaldson (1961) and was modified by Myers and Majluf (1984). It states that companies prioritize their sources of financing according to the cost of financing, preferring to raise equity as a financing means of last resort. Pecking order model postulated that the cost of financing increases with asymmetric information. 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).

Agency costs theory illustrates that firm’s capital structure is determined by agency costs, which includes the costs for both debt and equity issue. The costs related to equity issue may include: (1) The monitoring expenses of the principal (the equity holders); (2) the bonding expenses of the agent (the manager); (3) reduced welfare for principal due to the divergence of agent’s decisions from those which maximize the welfare of the principal. Besides, debt issue increases the owner-manager’s incentive to invest in high-risk projects that yield high returns to the owner-manager but increase the likelihood of failure that the debt holders have to share if it is realized. If debt-holders anticipate this a higher premium will be required, which in turns increase the costs of debt. Then, the agency costs of debt include the opportunity costs caused by the impact of debt on the investment decisions of the firm; the monitoring and bond expenditures by both the bondholders and the owner-manager; and the costs associated with bankruptcy and reorganization (Hunsaker, 1999). Since both equity and debt incur agency costs, the optimal debt-equity ratio involves a trade-off between the two types of cost. Agency costs arise due to the conflicts of interest between firm’s owners and managers. Jensen and Meckling (1976) introduce two types of conflicts: Conflicts between shareholders and managers; and conflicts between shareholders and bondholders.

2.3. Empirical Review

Chechet and Olayiwola (2014) investigated capital structure and profitability of Nigerian quoted firms using the agency cost theory perspective, with Panel data on a sample of 70 out of the 245 listed firms on the NSE for a period of 10 years 2000-2009. Two independent variables debt ratio (DR) and equity (EQT) were used as surrogates for capital structure while profitability was used as dependent variable. Using fixed-effects, random and Hausman Chi-square estimations the result showed that DR is negatively related with profitability while EQT positively relate to profitability. Based on the findings and conclusions they recommended that for firms’ experiencing agency conflicts and wishing to raise fund for operations or expansions, higher debt ratio should be given priority but the right combination of equity and debt must be observed.

Oke and Afolabi (2011) discovered positive relationship between firms’ performance and equity financing and debt-equity ratio but negative relationship between performance and debt financing when they investigated capital structure and performance of 5 quoted firms between 1999-2007 using debt financing, equity financing, and debt-equity ratio as surrogates of capital structure, and profitability index as measure of firms’ performance using

panel data regression model. They attributed the result of the study to high cost of borrowing in the country.

3. METHODOLOGY

A sample of 10 out of 23 banks was purposively selected based on their performance in the stock market. Panel data was sourced from the financial statement of these 10 selected commercial banks over the 14 year- period, spanning from 2000 to 2013. Two static models were employed in the study in which debt financing, equity financing, and debt-equity ratio stand as measures of capital structure, while return on asset and return on equity were used as corresponding measures of organizational performance. Dynamic model employed in the study captured capital structure with debt-equity ratio while organization performance was captured by return on asset. Techniques used in the study included the pooled OLS estimator, fixed effect estimator and random effect estimator analysis. The model was estimated at 5% significant level.

3.1. Model Specification

With reference to the empirical researches cited above, this study specifies two models which helps to capture the influence of capital structure (debt finance [DF], equity finance [EF] and debt-equity ratio) of the selected commercial banks on their performance (return on asset [ROA] and return on equity [ROE]). The granger causality model followed the specification presented in Gujarati and Porter (2009) using the ROA as performance measures and debt-equity ratio as capital structure proxy to test the causality relationship between capital structure and performance of commercial banks in Nigeria. These two models are specified in linear from:

$$ROA_{it} = \alpha_0 + \alpha_1 DF_{it} + \alpha_2 EF_{it} + \alpha_3 DER_{it} + U_1 \quad (1)$$

$$ROE_{it} = \beta_0 + \beta_1 DF_{it} + \beta_2 EF_{it} + \beta_3 DER_{it} + U_2 \quad (2)$$

$$ROA_t = \sum_{i=1}^k \rho_i ROA_{t-1} + \sum_{j=1}^k \theta_j DER_{t-1} \quad (3)$$

$$DER_t = \sum_{i=1}^k \gamma_i DER_{t-1} + \sum_{j=1}^k \ddot{a}_j ROA_{t-1} \quad (4)$$

Where ROA= return on asset, ROE=return on equity, DF=debt finance, EF=equity finance, DER=debt equity ratio, U=stochastic error term, $\alpha_{0,1,2,3}$ $\beta_{0,1,2,3}$ $\tilde{n}_i = 1,2,3,\dots,n$ $\dot{e}_j = 1,2,3,\dots,n$ $\ddot{a}_i = 1,2,3,\dots,n$ $\ddot{a}_j = 1,2,3,\dots,n$ are all parameter estimates of the corresponding models.

3.2. Variables Description

Return on assets (ROA) which measures efficiency of the business in using its assets to generate net income is obtained from the ratio of annual net income to average total assets of a business during a financial year. Return on equity (ROE) which shows profitability of stockholders’ investments is obtained from net income as percentage of shareholder equity (that is, profit after tax/equity). Debt finance (DF) is the amount of fund raised through borrowing to finance the operation of an organization for a specified period of time usually in a financial year. Equity finance (EF) is the amount of financing done by issue of shares of common stock to investors.

Debt-to-equity (D/E) ratio is a leverage ratio which measures the degree to which the assets of the business are financed by the debts and the shareholders' equity of a business is the ratio of total liabilities of a business to its shareholders' equity.

3.3. Estimation Technique

In an attempt to know the most reliable estimation between the fixed effect estimation and the random effect estimation, Hausman test was conducted to test if there is a substantial difference between the estimates of the fixed effect estimator and that of the random effect estimator. The null hypothesis underlying the test is that fixed effect estimates do not differ substantially from the random effect estimates.

4. DATA PRESENTATION AND ANALYSIS

Fixed effect parameter estimates (time specific) for Model 1 and Model 2 are presented in the Tables 1 and 2.

4.1. Hausman Test

In an attempt to know the most reliable estimation between the fixed effect estimation and the random effect estimation, Hausman test was conducted to test if there is a substantial difference between the estimates of the fixed effect estimator and that of the random effect estimator. The null hypothesis underlying the test is that fixed effect estimates do not differ substantially from the random effect estimates. Notably the test statistics developed by Hausman has an asymptotic Chi-square distribution as presented in Table 3.

Table 3 reveals a Chi-square value of 340.23 and 211.05 for Models 1 and 2 alongside probability values of 0.0000 and 0.0048. Thus the Hausman test for the two models report enough evidence to reject the null hypothesis of no substantial difference between the fixed effect and random effect estimates, in favor of the alternative hypothesis that there is a substantial difference between fixed effect and random effect estimates. Thus, rejection of the null hypothesis implies that error component model (random effect estimator) is not appropriate because the random effects are probably correlated with one or more regressors. Hence the most reliable (most consistent and efficient) estimator for the study is the fixed effect (one-way effect) estimation presented in Tables 1 and 2 for Models 1 and 2 respectively.

4.2. Interpretation of Results

$$ROA_{it} = \alpha_0 + \alpha_1 DF_{it} + \alpha_2 EF_{it} + \alpha_3 DER_{it} + U_1 \tag{1}$$

$$ROA = 0.09 - 2.30 - 2.55 - 0.00$$

$$S.E = (0.02) (1.26) (4.03) (0.00)$$

$$T\text{-test} = (4.99) (-1.82) (-0.63) (-1.06)$$

$$ROE_{it} = \beta_0 + \beta_1 DF_{it} + \beta_2 EF_{it} + \beta_3 DER_{it} + U_2 \tag{2}$$

$$ROE = 0.32 - 9.80 - 8.46 + 0.03$$

$$S.E = (0.01) (1.26) (4.03) (0.00)$$

$$T\text{-test} = (0.56) (3.72) (1.19) (0.002)$$

Table 1: Fixed effect parameter estimates (time specific)

Model 1

SERIES: ROA DF EF DER				
Variable	Coefficient	Standard Error	T-Test values	P
C	0.0938636	0.0188246	4.99	0.000
DF	-2.30e-11	1.26e-11	-1.82	0.071
EF	-2.55e-13	4.03e-13	-0.63	0.528
DER	-0.0000983	0.0000924	-1.06	0.290
Period-specific effects				
2001	-0.0370059	0.0261943	-1.41	0.160
2002	-0.0416531	0.0264413	-1.58	0.118
2003	-0.0358878	0.0264815	-1.36	0.178
2004	-0.0610598	0.0263213	-2.32	0.022*
2005	-0.061318	0.0263375	-2.33	0.022*
2006	-0.0538226	0.0266488	-2.02	0.046*
2007	-0.051965	0.0270229	-1.92	0.057
2008	-0.0392974	0.0280052	-1.40	0.163
2009	-0.0398059	0.0282111	-1.41	0.161
2010	-0.0347996	0.0276749	-1.26	0.211
2011	-0.0326615	0.030123	-1.08	0.280
2012	-0.0294149	0.030868	-0.95	0.342
2013	0.0131978	0.0318329	0.41	0.679

Source: Author's Computation, (2015). R²=0.1481, F-statistics=1.34, P (F-stat)=0.1862

Table 2: Fixed effect parameter estimates (time specific)

Model 2

SERIES: ROE DF EF DER				
Variable	Coefficient	Standard error	T-Test Values	P
C	0.3248618	0.5548247	0.59	0.559
DF	-9.80e-10	3.72e-10	-2.64	0.009
EF	-8.46e-12	1.19e-11	-0.71	0.477
DER	0.0278484	0.0027233	10.23	0.000
Period-specific effects				
2001	0.0164333	0.7720367	0.02	0.983
2002	-0.427449	0.7793148	-0.55	0.584
2003	-0.1165172	0.7805017	-0.15	0.882
2004	-0.0986387	0.7757792	-0.13	0.899
2005	-0.1344802	0.7762549	-0.17	0.863
2006	-0.230018	0.7854315	-0.29	0.770
2007	-0.1465287	0.7964572	-0.18	0.854
2008	0.7603332	0.8254102	0.92	0.359
2009	0.8207109	0.8314785	0.99	0.326
2010	1.558748	0.8156739	1.91	0.058
2011	0.5359879	0.8878273	0.60	0.547
2012	1.890024	0.9097867	2.08	0.040*
2013	2.418163	0.9382251	2.58	0.011*

R²=0.5047, F-statistics=7.83, P (F-stat)=0.0000

Table 3: Hausman test

Models	Chi-square stat	Probability
Model 1	340.23	0.0000
Model 2	211.05	0.0048

Source: Author's Computation (2015)

4.3. Discussion of the Findings

The analysis on the impact of capital structure on organizational performance of commercial banks is presented in the Tables 1 and 2. The results obtained from the models indicate that the overall

coefficient of determination (R) shows that the 0.14 for ROA and 0.50 for ROE meaning that 14% and 50% change in the dependent variables (ROA) and (ROE) respectively are caused by the independent variables (DF, EF and DER), which implies that all the included variables can only explain about 14% of the systematic variation in return on asset in Model 1 and 50% variation in return on equity in model.

The result of the first estimated model revealed that debt financing negatively and significantly influence return on asset of commercial banks in Nigeria ($\beta = -2.27e-11$, $P = 0.008 < 0.05$), Equity finance exert positive and non-significant influence on return on asset ($\beta = 1.76e13$, $P = 0.713 > 0.05$) while debt-equity ratio had negative and non-significant influence on return on asset ($\beta = -0.0001804$, $P = 0.109 > 0.05$). The second estimated model revealed that the impact of debt financing on return on equity is positive and non-significant ($\beta = 1.26e-11$, $P = 0.960 > 0.05$), equity finance had negative and non-significant impact on return on equity ($\beta = -7.25e-12$, $P = 0.613 > 0.05$) while debt-equity ratio exert positive and significant influence on return on equity ($\beta = 0.0227248$, $P = 0.000 < 0.05$). The observed significant impact of debt and debt-equity ratio on organizational performance is in consonance with the discoveries of researchers including Aftab et al. (2012), Oke and Afolabi (2011), Velnampy and Niresh (2012) but contradicts the discoveries of Siddiqui and Shoaib (2011), Pratomo and Ismail (2007), Berger and di Patti (2002).

5. SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATION

This paper evaluated the impact of capital structure on organizational performance using 10 selected commercial banks in Nigeria between 2000 and 2013. The study reveals that debt financing negatively and significantly influence return on asset of commercial banks in Nigeria, Equity finance exert positive and non-significant influence on return on asset, while debt-equity ratio had negative and non-significant influence on return on asset. The second estimated model revealed that the impact of debt financing on return on equity is positive and non-significant, equity finance had negative and non-significant impact on return on equity, while debt-equity ratio exert positive and significant influence on return on equity. Stakeholder of commercial banks should ensure that the optimum capital structure is entrenched to balance between financial risk and business risk of their operation. To do so debt-equity ratio could be varied at intervals, in other to be able to juxtapose between the capital structures available to the organization.

Premise on the findings, the study concludes that the impact of capital structure on organizational performance of commercial banks in Nigeria largely depends on the level of debt financing but up to the optimum capital structure. Increase in the capital structure through use of higher equity-debt ratio has the tendency to impede the performance of the commercial measured in terms of return on equity. Secondly, this research has contributed to the enrichment of literature on funding decision in banks especially for investors who snub further external financing on fixed rate capital.

Based on the findings and conclusion drawn, the study therefore recommends that management of commercial banks should ensure that the right optimum capital structure is always engaged by varying the debt-equity ratio at intervals, in order to enhance the performance of the banks in terms of the ROA and ROE. Shareholders should be carried along in the process that calls for extra funding.

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