



## OPTIMUM CAPITAL STRUCTURE AND ITS IMPACT ON BANKING PERFORMANCE – A GLIMPSE

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### Abstract

This paper examines the impact of optimum capital structure on bank performance. The capital structure is the mix of equity and debt fund. Capital Structure is the Ratio of long-term sources of finance in the total capital of the firm includes 'Proprietor's Funds and 'Borrowed Funds(Proprietors Funds include equity capital, preference capital, reserves and surpluses retained earnings and Borrowed Funds include long-term debts such as loans from financial institutions, debentures etc). The Optimal Capital Structure indicates the best debt-to-equity ratio for a firm that maximizes its value. Putting it simple, the optimal capital structure for a company is the one which proffer a balance between the idyllic debt-to-equity ranges thus minimizing the firm's cost of capital. The main aim of present study is to determinants of optimum capital structure and its impact of banking performance. Performance is measured by return on assets, return on equity and earnings per share. Determinants of capital structure contains long term debt to capital ratio, short term debt to capital ratio and total debt to capital ratio. The research study is descriptive and analytical research which is conducted on the basis of secondary data. Lastly, some suggestions have given by the researcher which the banks may follow. Hence, the research may contribute in providing a new way to the banks for capital structure decision.

**Key Words:** Optimal Capital Structure, cost of capital, Banking Performance, Return on Assets, Return on Equity, Earning per Share.

### Introduction

In order to run and manage a company, funds are needed. Right from the promotional stage up to end, financial plays an important role in a company's life. Financial managers are fronting difficulties in just determining the optimal capital structure. Optimum capital structure means with a minimum weighted average cost of capital and thus maximize the value of organization. A business utilizes several kinds of financing to operate a company efficiently. Capital structure is a financial tool that helps to determine how firms choose their capital structure, a firms capital structure is then the composition or structure of its liabilities. Financial aspect is a tool which point out the financial strengths, weaknesses, opportunities and threats. On the additional hand today capital structure is one of the most significant financial decisions for any business and firm. This decision is authoritative because the organizations need to expand return to different organizations and also have an effect on the value of the organization. The basic concept behind the capital structure is the benefits of financial leverage. The benefits those are related with the tax shield because interest on debt financing saves the taxes on earnings. Therefore the capital structure plays a vital role in firms' financial performance. The relative proportion of various sources of funds used in a business is termed as financial structure. Capital structure is a part of the financial structure and 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. If the capital structure is at optimal level it gives significant positive impacts on firms' financial performance otherwise the impact may be negative. The hope is that the right application of capital structure theory and agreement with principles will decrease a bank's risk.

The concept is generally described as the combination of debt & equity that make the total capital of firms. The proportion of debt to equity is a strategic choice of corporate managers. Capital structure decision is the vital one since the profitability of an enterprise is directly affected by such decision. Hence, proper care and attention need 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. Capital is a vital part of that statement. The term "capital structure" of an enterprise is actually a combination of equity shares, preference shares and long term debts. 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, (I.M.Pandey, 2009).

### Review of Literature

Some authors got positive relationship; some got negative relationship while others got mixed or no relationship between capital structure and firm's performance. Some of the major contributions in the literature on this topic have been discussed in the below.



Pandey (1988), "The Financial Leverage in India- A Study Indian Management" revealed that the tendency of large size companies is to concentrate in the high-level leverage class, but it was difficult to conclude that the size has an impact on the degree of leverage.

Krishnaswami and Narayanasamy (1990), "Relationship between Capital Structure and Cost of Capital in Co-operative: An Empirical study Finance India" stated that capital structure theories, by and large, conclude that leverage is beneficial to private enterprises and debt is the cheapest source of finance for them.

Subarna Sarkar (1994), "Capital Structure and productivity of capital in Indian Corporate Sector" found that a greater debt-oriented financing in public sector enterprises and private sector companies shows that the profits are retained in business for augmenting the resources.

Ram Kumar Kakani (1999), "The Determinants of Capital Structure-An econometric Analysis" found that diversification strategy and size were found to be of significant strategy and sizes were found to be of insignificant in deciding the leverage level of the firm.

Kotrappa (2000) stated that the choice between debt and equity sources of capital for a corporate borrower is greatly influenced by factors viz., taxes on corporate income, inflation, controlling interest and capital market reforms.

Rabul Alam. S.M. and Dr.Syed Zabid Hossain (2000), "Planning and control of Capital Structure of the ship building industry in Bangladesh-case study" found that the capital structure management of Khulne Shipyard Ltd. was in a poor shape because the interest coverage ratio was negative, as there is the possibility of non-payment of interest charges to creditors.

Singh R (2003), "Profitability management in banks under deregulated environment" has analyzed profitability management of banks under the deregulated environment with some financial parameters of the major four bank groups i.e. public sector banks, old private sector banks, new private sector banks and foreign banks, profitability has declined in the deregulated environment. He emphasized to make the banking sector competitive in the deregulated environment. They should prefer noninterest income sources.

Sooden Meenakshi & Bali (2004) has stressed that the public sector banks should give emphasize on both economic and social profits in a desirable mix to make themselves a strong pillar of modern development framework. They analyzed the profitability of the public sector banks in both pre and post reform period for the year 1982 to 2000. In late 1990s economic profitability of public sector banks started improving and priority sector lending started falling. It led to erosion of social profitability in public sector banks.

Singh Bhupinder Pal (2004) The objective of the present study is to analyse the impact of banking reforms on technical efficiency of public sector banks, to find interbank variation in technical efficiency, to find impact of banking sector reforms on the total factor productivity growth of the Indian public sector banks. Time period for the study is taken from 1987-2003. Data Envelopment Analysis and DEA- Malmquist Product Index have been used. It is concluded that banking sector reforms had a favourable impact on productive efficiency of Indian Public Sector Banks.

Singh Sultan (2007) made an attempt to assess the impact of reforms on the operational performance and efficiency of the commercial banks in India. Ratio Analysis has been used as a major tool for assessing the performance of the selected commercial banks. The hypothesis that the profitability position has improved in reform period may be accepted to some extent. It was observed that in the PSBs the size of NPAs has also been reduced to some extent and quality of service has improved in reform period. The priority sector lending has registered a decline in the deregulation era.

Rangarajan C (2007) in lecture focuses on the banking sector reforms and improvement in the performance of Indian banking Industry. It is held that the development of the financial system is essential for sustaining higher economic growth. Reform measures were initiated in India so that banks can overcome external constraints and operate with greater flexibility. Favourable impact of banking sector reforms on Indian banking Industry is also shown. Proper attention should be paid to issues like consolidation, capital adequacy, risk management and customer service. Productivity and Profitability can be improved by combining corporate planning with organisational restructuring. Financial inclusion and governance have emerged as the key issues for socio-economic development.

Ebru Caglayan (2010) has studied on "The Determinants of Capital Structure: Evidence from the Turkish Banks" This



paper examines the capital structure of banks, from the perspective of the empirical capital structure literature, for non-financial firms by using the panel data analysis method. It investigates which capital structure theories can explain the capital structure choice of the banks. The paper also identifies two sub-periods to determine the differences across determinants of capital structure in the different periods for Turkish banks after the financial crises and restructuring periods. The findings show that size and market to book have positive effects whereas tangibility and profitability have negative effects on the book leverage in all periods. The results of the analysis indicate some evidence of the pecking order theory's expectations.

### **Research Problem**

This study is to review the different determinants of optimum capital structure in the banking industry as it affects the whole form of the organization. So it is very important to have a clear idea about these factors and cost of different sources in the banking industry and the problem in the study is to review the effective determinant of capital structure.

### **Methods of Collecting Data**

Since the report required studying the theoretical as well as practical aspects of Project Finance, the books have provided in the theoretical aspects of the study. To get the latest information, Internet was also used as a medium at various stages. The data for this paper has been attained from the secondary sources.

### **Need and significance of the study**

Optimum capital structure decision is one of the strategic decisions taken by the financial management. Considerable attention is required to decide the mix up of various sources of finance. A judicious and right capital structure decision reduces the cost of capital and increase the value of a firm while a wrong decision can adversely affect the value of the firm. As discussed earlier, various sources of finance differ in terms of risk and cost. Hence, there is utmost need of designing an appropriate capital structure. Capital structure decisions are of great significance due to the following reasons:

1. Capital structure determines the risk assumed by the firm.
2. Capital structure determines the cost of capital of the firm.
3. It affects the flexibility and liquidity of the firm.
4. It affects the control of owners on the firm.

### **Objective of the study**

- To review the optimum capital structure and its impact of firms and banks in general.

### **Scope of the study**

The research design is the conceptual structure within which research conducted. It constitutes the blue print for the collection, measurement and analysis. This research is of Explanatory & analytical in nature. In explanatory & analytical research we have sufficient data on the concept and research material. Because many researcher have been done the work on the concept.

### **Forms/Patterns of Capital Structure**

The capital structure of a new company may consist of any of the following forms:

- a) Capital structure with Equity shares only.
- b) Capital structure with Equity and Preferences Shares.
- c) Capital structure with Equity Shares and debentures.
- d) Capital structure with Equity Shares, Preferences Shares and Debentures.

The choice of an appropriate Capital structure depends on a number of factors such as the nature of the company's business, regularity of earnings, conditions of the money market, attitude of the investors, etc. It is regarding the basic difference between debt and equity. Debt is a liability on which interest has to be paid irrespective of the company's profits, while equity consists of shareholders or owners funds on which payment of dividend depends upon the company's profits. A high proportion of the debt content in the capital structure increases the risk and may lead to financial insolvency of the company in adverse times. However, raising funds through debt is cheaper as compared to raising funds through shares. This is because interest on debt is allowed as an expense for tax purpose. Dividend is considered to be an appropriate of profits hence payment of dividends does not in any tax benefit to the company. This means if a company, which is in 50% tax bracket, pays interest at 12% on its debentures; the effective cost to it comes only to 6%. While if the amount is raised by issue of 12% preference shares, the cost of raising the amount would be 12%. Thus, rising of funds by borrowing is cheaper resulting in higher availability of profits for shareholders. This increases the earnings per equity share of the company which is basic objective of the finance manager.



### **Optimal Capital Structure**

The capital structure decision can influence the value of the firm through the cost of capital and trading on equity or leverage. The optimum capital structure may be defined as “that capital structure or combination of debt and equity that leads to the maximum value of the firm. Optimal capital structure ‘maximizes the value of the company and hence the wealth of its owners and minimizes the company’s cost of capital’ (Solomon, Ezra, The Theory of Financial Management). Thus, every firm should aim at achieving the optimal capital structure and then to maintain it.

A firm should try to maintain an optimum capital structure with a view to maintain financial stability. The optimum capital structure is obtained when the market value per equity share is the maximum. It may, therefore, be defined as that relationship of debt and equity securities which maximizes the value of a company’s share in the stock exchange. In case a company borrows and this borrowing helps in increasing the value of the company’s shares in the stock exchange, it can be said that the borrowing has helped the company in moving towards its optimum capital structure. In case, the borrowing results in fall in market value of the company’s equity shares, it can be said that the borrowing has moved the company away from its optimum capital structure.

The objective of the firm should, therefore, be to select a financing or debt-equity mix which leads to maximum value of the firm. The optimum capital structure and its implications have been expressed by Ezra Soloman in the following words:

“Optimum leverage can be defined as that mix of debt and equity which will maximise the market value of a company, i.e., the aggregate value of the claims and ownership interests represented on the credit side of the balance sheet. Further, the advantages of having an optimum financial structure, if such an optimum does exist, are two-fold; it minimises the company’s cost of capital which, in turn, increases its ability to find new wealth-creating investment opportunities. Also, by increasing the firm’s opportunity to engage in future wealth-creating investment it increases the economy’s rate of investment and growth.”

### **Considerations**

The following considerations should be kept in mind while maximizing the value of the firm in achieving the goal of optimum capital structure:

- 1) The firm should take advantage of favourable financial leverage. In other words, if the ROI is higher than the fixed cost of funds, they may prefer raising funds having a fixed cost to increase the return to equity shareholders.
- 2) The firm should avoid a perceived high risk capital structure. This is because if the equity shareholders perceive an excessive amount of debt in the capital structure of the company, the price of the equity shares will drop. The company should not, therefore, issue debentures or bonds whether risky or not, if the investors perceive an excessive risk and, therefore, it is likely to depress the market prices of equity shares.
- 3) If the return on investment is higher than the fixed cost of funds, The Company should prefer to raise funds having a fixed cost, such as debentures, loans and preference share capital. It will increase earnings per share and market value of the firm. Thus, a company should, make maximum possible use of leverage.
- 4) When debt is used as sources of finance, the firm saves a considerable amount in payment of tax as interest is allowed as a deductible expense in computation of tax. Hence, the effective cost of debt is reduced, called tax leverage. A company should, therefore, take advantage of tax leverage.
- 5) The firm should avoid undue financial risk attached with the use of increased debt financing. If the shareholders perceive high risk in using further debt-capital, it will reduce the market price of shares.
- 6) The capital structure should be flexible.

According to Net Operating Income (NOI) Approach, the total value of the firm remains constant irrespective of the debt-equity mix or the degree of leverage. The market price of equity shares will, therefore, also not change on account of change in debt-equity mix. Hence, there is nothing like optimum capital structure. Any capital structure will be optimum according to this approach.

In those cases where corporate taxes are presumed, theoretically there will be optimum capital structure when there is 100% debt content. This is because with every increase in debt ‘content k’ declines and the value of the firm goes up. However, due to legal and other provisions, there has to be a minimum equity. This means that optimum capital structure will be a level where there can be maximum possible debt content in the capital structure.

### **Determination of Optimum Capital Structure**

The optimum capital structure, the value of an equity share is the maximum while the average cost of capital is the minimum. The value of an equity share mainly depends on earning per share. So long the ‘Return on Investment’ (ROI) is more than the



cost of borrowing, each rupee of extra borrowing pushes up the earning per equity share which, in turn, pushes up the market value of the share. It means the company can borrow till the interest rate on borrowings is equal to or does not exceed the return from the project. However, each extra rupee of borrowing increases the risk and, therefore, in spite of increase in the earning per equity share, the market value of the equity share may fall because of investors taking it as a more risky company. Of course, in some cases, in spite of increase in risk, the value of a company's equity shares may increase because of investors' speculation on future profits.

It is almost impossible to precisely measure the fall in the market value of an equity share on account of increase in risk due to high debt content. Market factors are highly psychological, complex and do not follow always accepted theoretical principles since capital market are never perfect.

Thus it is not possible to find out the exact debt-equity mix where the capital structure would be optimum. Of course, a range can be determined on the basis of empirical study within which if the company maintains its debt-equity mix, the investors will not discount its shares.

For example, a company belongs to an industry where the average debt-equity ratio is 1:1. Empirical studies disclose that the investors do not discount the value of the company's shares so long debt-equity ratio remains within 40% of the industry's average, i.e., between, 0.6:1 and 1.4:1.

This means that if the company maintains capital structure within this range, the value of the equity share will not decline due to more risk perceived by the investors. In order to have the maximum tax advantage on the interest payable, the company may contain debt-equity ratio near the top of the range keeping in view other factors such as profitability, solvency, flexibility, control, etc.

The capital structure so arrived at may not be optimum but would be the most reasonable under the circumstances. Some people, therefore, prefer to use the term 'appropriate or sound capital structure' in place of the term 'optimum capital structure', the former being more a realistic term than the latter.

#### **Essential features of a sound capital mix**

A sound or an appropriate capital structure should have the following essential features:

- 1) Maximum possible use of leverage.
- 2) The capital structure should be flexible.
- 3) To avoid undue financial / business risk with the increase of debt.
- 4) The use of debt should be within the capacity of a firm` the firm should be in a position to meet its obligations in paying the loan and interest charges as and when due.
- 5) It should involve minimum possible risk of loss of control.
- 6) It must avoid undue restriction in agreement of debt

#### **Features of an appropriate capital structure**

A capital structure will be considered appropriate if it possesses the following features:

##### **Profitability**

The capital structure of the company should be most profitable. The most profitable capital structure is one that tends to minimise the cost of financing and maximise earning per equity share.

##### **Solvency**

The pattern of capital structure should be so devised as to ensure that the firm does not run the risk of becoming insolvent. Excess use of debt threatens the solvency of the company. The debt content should not, therefore, be such that it increases risk beyond manageable limits.

##### **Flexibility**

The capital structure should be such that it can be easily manoeuvred to meet the requirements of changing conditions. Moreover, it should also be possible for the company to provide funds whenever needed to finance its profitable activities.

##### **Conservatism**

The capital structure should be conservative in the sense that the debt content in the total capital structure does not exceed the limit which the company can bear. In other words, it should be such as is commensurate with the company's ability to generate future cash flows.



### **Control**

The capital structure should be so devised that it involves minimum risk of loss of control of the company. The above principles regarding an appropriate capital structure are as a matter of fact militant to each other. For example, raising of funds through debt is cheaper and, therefore, in accordance with the principle of profitability, but it is risky and, therefore, goes against the principle of solvency and conservatism. The prudent financial manager should try to have the best out of the circumstances within which the company is operating. The relative importance of each of the above features will also vary from company to company.

For example one company may give more importance to flexibility as compared to conservatism while the other may consider solvency to be more important than profitability. However, the fact remains that each finance manager has to make a satisfactory compromise between the management's desire for funds and the trends in the supply of funds.

### **Capital Structure Theories**

There are different viewpoints on the impact of the debt-equity mix on the shareholder's wealth. There is a viewpoint that strongly supports the argument that the financing decision has major impact on the shareholder's wealth, while according to others, the decision about the financial decision is irrelevant as regards maximization of shareholder's wealth. A great deal of controversy has developed over whether the capital structure of a firm as determined by its financing decision affects its cost of capital. Traditionalists argue that the firm can lower its cost of capital and increase the market value per share by the judicious use of leverage. Modigliani & Miller, on the other hand, argue that in the absence of taxes and other market imperfections, the total value of the firm and its cost of capital are independent of capital structure. There are four major theories explaining the relationship between capital structure, cost of capital and value of the firm:

1. Net Income Approach
2. Net Operating Income Approach
3. Traditional Approach
4. Modigliani-Miller Approach

There are certain underlying assumptions made in order to present the theories in a simple manner. The assumptions are as follows:

1. The firm employs only two types of capital- debt and equity.
2. There are no corporate taxes. This assumption is removed later.
3. The firm pays 100% of its earnings as dividend.
4. The firm's total assets are given and they do not change, i.e. the investment decisions are assumed to be constant.
5. The firm's total financing remains constant.
6. The operating earnings are not expected to grow.
7. The business risk remains constant and is independent of capital structure and financial risk.
8. All investors have the same subjective probability distribution of the future expected operating earnings for a given firm.
9. The firm has a perpetual life.

### **Net Income Approach**

The approach has been suggested by David Durand. According to this approach, the capital structure decision is relevant to the valuation of the firm, i.e., a change in the capital structure will lead to a corresponding change in the overall cost of capital as well as the total value of the firm. If the ratio of debt to equity is increased the weighted average cost of capital will decline, while the value of the firm as well as the market price of ordinary shares will increase. Conversely, a decrease in the leverage will cause an increase in cost of capital and a decline in the value of the firm as well as the market price of equity shares.

### **The Net Income Approach is based on three assumptions**

1. There are no taxes.
2. The cost of debt is less than the equity-capitalization rate or cost of equity.
3. The use of debt does not change the risk perception of the investors.

The implication of the above assumptions is that as the degree of leverage increases, the proportion of an inexpensive source of funds, i.e., debt in the capital structure increases. As a result the weighted average cost of capital tends to decline, leading to an increase in the total value of the firm. Thus, the cost of debt and cost being constant, the increased use of debt will magnify the shareholder's earnings and thereby the market value of the ordinary shares. With a judicious mixture of debt and



equity, a firm can evolve an optimum capital structure will be the one at which value of the firm is the highest and the overall cost of capital is the lowest. At that structure the market price per share would be the maximum. If the firm uses no debt the overall cost of capital will be equal to the equity-capitalization rate. The weighted average cost of capital will decline and will approach the cost of debt as the degree of leverage reaches one. We can graph the relationship between the various factors with the degree of leverage. The degree of leverage is plotted along the X-axis while the percentage rates for cost of debt, equity and overall cost are on the Y-axis. Due to the assumption that cost of debt and equity are constant as the degree of leverage changes, we find that both the curves are parallel to the X-axis. But as the degree of leverage increases, the overall cost decreases and approaches the cost of debt where leverage is one. At this point the firm's overall cost of capital would be the minimum. The significant conclusion is that the firm can employ almost 100 per cent debt to maximize its value.

### **Net Operating Income Approach**

This approach is also suggested by David Durand. It is diametrically opposite to the Net Income Approach. The essence of this approach is that the capital structure decision of the firm is irrelevant. Any change in leverage will not lead to any change in the total value of the firm and the market price of shares, as the overall cost of capital is independent of the degree of the leverage.

### **The Net Operating Income Approach is based on the following propositions**

1. Overall cost of capital is constant: The overall cost of capital remains constant for all degrees of leverage. The value of the firm, given the level of EBIT is determined by  $V = EBIT/k_o$ .
2. Residual value of equity: The value of equity is residual which is determined by deducting the total value of debt from the total value of the firm.
3. Changes in cost of equity capital: The cost of equity increases with the degree of leverage. With the increase in the proportion of debt the financial risk of the shareholders will increase. To compensate for the increased risk, the shareholders would expect a higher rate or return.
4. Cost of debt: The cost of debt has two parts: explicit and implicit cost. The explicit cost is represented by the rate of interest. Irrespective of the degree of leverage the firm is assumed to be able to borrow at a given rate of interest. This implies that the increasing proportion of debt in the financial structure does not affect the financial risk of the lenders and they do not penalize the firm by charging higher interest. Increase in the degree of leverage causes an increase in the cost of equity. This increase in cost of equity being attributable to the increase in debt is implicit part of cost of debt. Thus the advantage associated with the use of debt supposed to be a cheaper source of funds in terms of the explicit cost is exactly neutralized by the implicit cost represented by the increase in cost of equity. As a result the real cost of debt and the real cost of equity according to Net Operating Income are the same and equal to overall cost.

No matter what the degree of leverage is, the total value of the firm will remain constant. The market price of shares will also not change with the change in the debt equity ratio. There is nothing such as an optimum capital structure. Any capital structure is optimum according to Net Operating Income Approach.

### **Traditional Approach**

The Traditional Approach or the Intermediate Approach is a mid-way approach between the Net Income and Net Operating Income approach. It partly contains features of both the approaches. The traditional approach accepts that the capital structure of the firm affects the cost of capital and its valuation. However, it does not subscribe to the Net Income approach that the value of the firm will necessarily increase with all degrees of leverages. It subscribes to the Net Operating Income approach that beyond a certain degree of leverage, the overall cost of capital increases resulting in decrease in the total value of the firm. However, it differs from Net Operating Income approach in the sense that the overall cost of capital will not remain constant for all the degree of leverages. The essence of the traditional approach lies in the fact that a firm through judicious use of debt-equity mix can increase its total value and thereby reduce its overall cost of capital. According to this approach, up to a point, the content of debt in the capital structure will favourably affect the value of the firm. However, beyond that point, the use of debt will adversely affect the value of the firm. At this level of debt-equity mix the capital structure will be optimum.

### **Modigliani-Miller Approach**

The Modigliani-Miller theorem, proposed by Franco Modigliani and Merton Miller, forms the basis for modern thinking on capital structure, though it is generally viewed as a purely theoretical result since it assumes away many important factors in the capital structure decision. The theorem states that, in a perfect market, the value of a firm is irrelevant to how that firm is financed. This result provides the base with which to examine real world reasons why capital structure is relevant, that is, a



company's value is affected by the capital structure it employs. If capital structure is irrelevant in a perfect market, then imperfections which exist in the real world must be the cause of its relevance. The theories below try to address some of the imperfections, by relaxing assumptions made in the M&M model. One of the main theories of how firms make their financing decisions is the Pecking Order Theory, which suggests that firms avoid external financing while they have internal financing available and avoid new equity financing while they can engage in new debt financing at reasonably low interest rates.<sup>8</sup> The pecking order theory is based on the assertion that managers have more information about their firms than investors. This disparity of information is referred to as asymmetric information. Other things being equal, because of asymmetric information, managers will issue debt when they are positive about their firms' future prospects and will issue equity when they are unsure. Another major theory is the Trade-Off Theory in which firms are assumed to trade-off the tax benefits of debt with the bankruptcy costs of debt when making their decisions. An emerging area in finance theory is right-financing whereby investment banks and corporations can enhance investment return and company value over time by determining the right investment objectives policy framework, institutional structure, source of financing (debt or equity) and expenditure framework within a given economy and under given market conditions. One last theory about this decision is the Market timing hypothesis which states that firms look for the cheaper type of financing regardless of their current levels of internal resources, debt and equity. Trade-off theory allows the bankruptcy cost to exist. It states that there is an advantage to financing with debt (namely, the tax benefit of debts) and that there is a cost of financing with debt (the bankruptcy costs of debt). The marginal benefit of further increases in debt declines as debt increases, while the marginal cost increases, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing. Empirically, this theory may explain differences in D/E ratios between industries, but it doesn't explain differences within the same industry. 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. Thus, the form of debt a firm chooses can act as a signal of its need for external finance. The pecking order theory is popularized by Myers(1984) when he argues that equity is a less preferred means to raise capital because when managers (who are assumed to know better about true condition of the firm than investors) issue new equity, investors believe that managers think that the firm is overvalued and managers are taking advantage of this over-valuation. As a result, investors will place a lower value to the new equity issuance.

The determination of capital structure in practice involves considerations in addition to the concerns about earning per share, value and cash flow. A firm may have enough debt servicing ability but it may not have assets to offer as collateral. Attitudes of firms with regard to financing decisions may also be quite often influenced by their desire of not losing control, maintaining operating flexibility and have convenient timing and cheaper means of raising of funds.

According to Ezra Solomon and John Pringle, financial leverage affects both the magnitude and the variability of earnings per share and return on equity. For any given level of EBIT, the effect of increase in leverage is favourable if the percentage rate of operating return on assets is greater than the interest on debt and it is unfavorable if it is less. When EBIT varies over time, financial leverage magnifies the variation in earnings per share and return on equity. A great deal of controversy has developed over whether the capital of a firm as determined by its financing decision, affects its cost of capital. Traditionalists argue that the firm can lower its cost of capital and increase market value per share by the judicious use of leverage. Modigliani and Miller, on the other hand, argue that in the absence of taxes and other market imperfections, the total value of the firm and its cost of capital are independent of capital structure. This position is based on the notion that there is a conservation of investment value. No matter how you divide the pie between debt and equity claims, the total investment value of the firm stays the same. Therefore, leverage is said to be irrelevant. Hence, the proposed study makes a critical study of the capital structure of various companies over a period of a time. There are various industries like cement, pharmaceuticals, sugar, steel, petroleum, fertilizer, automobile etc. From among these, the proposed research shall study few companies in the pharmaceutical and engineering industry.

### **Conclusion**

A study of Optimum capital structure is very much needed in the present competitive globalised economic environment. Generally the features of an appropriate capital structure of a firm like, profitability, solvency, flexibility, conservatism, control, minimum cost, maximum return, minimum risk, proper liquidity, full utilization, balanced leverage, simplicity. But, the nature of firm is one which decides (or) determines the capital structure which means depends upon the nature of a firm the capital structure determinants are also subject to change. Banking sector is not exempted from this. Capital structure decision is critical for any firm for maximizing return to the various stake holders and also to enhance firms' ability to operate in a competitive environment. Therefore the vital issue confronting managers today is how to choose the mix of debt and equity to achieve optimum capital structure that would minimise the firm's cost of capital and improve return to owners of the business. Financial, managers make efforts to ascertain a particular combination that will maximize profitability and the





firm's market value. Banks generally play a crucial role in the economic development of every country. One critical decision banks face is the debt-equity choice. Among others, this choice is necessary for the profit determination of firms. What this means is that banks that are able to make their financing decision prudently would have a competitive advantage in the industry and thus making superior profits. Nonetheless, it is essential for us to recognize that this decision can only be wisely taken if banks know how debt policy influences their profitability.

An appropriate mix of capital structure should be adopted in order to increase the profitability of banks. For example the total debt contributed 50.5% in determining the net profit of the Banking Industry. That is in the case of higher debt, profitability will tend to decline. The reason behind this may be due to the high interest bearing securities engaged in the total debt. In addition to these an increase in the level of debt also increases the riskiness of banks. Therefore, banks should concern much on internal sources of financing in order to increase their profitability. Top management of every banking firm should make prudent financing decision in order to remain profitable and competitive. Banks in India must not only be interested in mobilizing deposits but must also be concerned with utilizing these deposits effectively and efficiently. To achieve that, banks must set competitive lending rates that would not discourage customers from accessing loans. The capital structure is a combination of long-term debt, preferred stock and common equity. If the capital structure is at optimal level it gives significant positive impacts on firms' financial performance otherwise the impact may be negative. The hope is that the right application of capital structure theory and agreement with principles will decrease a bank's risk.

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