ISSN: 0974-5823 Vol. 6 (Special Issue, Nov.-Dec. 2021)

*International Journal of Mechanical Engineering*

# Impact of Capital Structure on Financial Performance of Small Finance Banks

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***ABSTRACT***

The purpose of this research is to look into the effect of financial leverage on the financial performance of small Indian banks. Return on assets and return on equity are the dependent variables in this research. The independent variables in this study are debt ratio, debt to equity ratio, interest coverage ratio, and cash coverage ratio. From 2017 through 2021, a sample of six small financial banks was used. Secondary data is the type of information that is utilised. Purposive sampling was used to collect data. The panel data regression data analysis model was utilised. According to the findings, the debt ratio has a beneficial impact on both the return on assets and the return on equity. The debt-to-equity ratio has a good influence on the return on assets, but it has a considerably positive effect on the return on equity. Return on assets is unaffected by the interest coverage ratio, while return on equity is unaffected by the cash coverage ratio. The debt ratio and the debt-equity ratio can both be used to maximise shareholder profits and financial performance.

**Keywords:** financial leverage, financial performance and small financial bank.

## INTRODUCTION

Globalization has accelerated the development of the financial sector, which has resulted in advancements in technology and communication. Banks have been increasingly intertwined in terms of the economy as the financial industry has grown, helping the country's prosperity and progress. Because it influences the country's economy, the banking sector's development requires attention. Because they are financial institutions and a financial resource in a country, banks can benefit a country's economy, particularly in developing countries. The equity multiplier ratio is a measure of the relationship between a bank's selected financial assets and its overall equity (or financial leverage). The central bank, monetary financial institutions, and other financial intermediaries are all included in the banking industry (except insurance corporations and pension funds). Financial assets include currency, deposits, debt instruments, and loans. The market value of equity, excluding investment fund shares, is referred to as total equity. Banks, according to this argument, transmit money from surplus parties to parties in need. The money will be allocated in such a way that the bank's financial resources will be more efficient. Explain how the movement of funds from savers to borrowers is thought to serve as a container for the country's economic life. It is argued that business life in different industries, including the financial sector, is frequently insecure. The banking sector is supposed to adapt to every situation, even compete and maximise earnings for shareholders. As a result, the bank's financial performance must be taken into account in order to determine its efficiency. Shown that financial performance is particularly crucial to efficiency because banks are a major source of funding. Better financial success has prompted other businesses to improve and have a greater impact on the country's economy. imply that the quality of a company's financial performance is important because of the various stakeholders' desires.

Financial managers and shareholders are among the stakeholders. The financial manager wants to put money into the next project, but the stockholders who put money into it want to get paid dividends. Explain that financial success can be calculated in a variety of ways depending on the size and parameters employed and required by each organisation. Profitability is one of the financial ratios used by businesses to assess their financial success . Many studies have always utilised different financial ratios because they can illustrate the effectiveness and diverse information from financial performance and explain that financial performance can be quantified using the return on assets (ROA) and return on equity (ROE). Both of these profitability ratios are indicators of a company's capacity to evaluate the benefits it has reaped. A bank that has a high return on assets (ROA) and a return on equity (ROE) demonstrates that it can effectively manage its assets and equity. Its ability to improve financial performance will entice creditors and investors to take a stand in the future. I propose that return on assets (ROA) and return on equity (ROE) are two analytical procedures for evaluating a company's financial performance.

**Financial Leverage**

The term "financial leverage" refers to a combination of debt and equity. Financial leverage demonstrates a company's ability to secure loans that could result in higher total returns for shareholders. The company's capital structure is optimised as a result of this borrowing. The ultimate goal is to increase the company's market value and increase shareholder wealth. Financial leverage, according to the article, is a measure of a company's ability to employ loan money to fund future projects. Financial leverage is essential because it indicates a company's potential to improve returns to its owners by using fixed-cost assets or funds. It is crucial to analyse the choice of leverage in a corporation since leverage influences the uncertain future of risk management. Make the case that proper debt capital management will lead to improved corporate financial governance in the future. It is envisaged that obtaining this level of efficiency will boost financial performance value. According to him, financial managers must pay close attention to the utilisation of capital structures in their businesses since they are critical to the fulfilment of the wants and needs of the company's stakeholders. To reduce risks and boost profits, financial managers must be able to improve the company's capital structure. Shareholders, employees, customers, and creditors all benefit from a well-structured capital structure. Financial leverage is quantified using four ratios: debt ratio, debt-to-equity ratio, interest coverage ratio, and cash coverage ratio, according to the author.

**Review Of literature**

Goyal AM (2013) has explained about the profitability and the strength of Government banks in India. He also explained about how the banks perform effectively and the capital structure of the banks. He mainly used multivariate analysis in order to analyse the relationship between various components like earning per share, return on equity and return on assets with the help of capital structure.

RajkumarP (2014) mainly analyse the relationship between the monetary leverage and performance of John keells in sri lanka, the period he took for the study was from 2007- 2012.from his result we can clearly interpret that there is negative relationship between the components i.e. monetary performance and leverage of that company.

Quadra (2016) mainly analyse the effectiveness of capital structure on performance. The study was conducted among various Indian banks and the period he took for the study was 6 years. The main components he took for the study to analyse the profitability was NIM, NP and ROCE and Debt/Total equity and Debt/Total Fund ratios are used as a components of capital structure. From the study we can clearly interpret that the debt/equity has decreasing throughout this shows that the risk is reducing among various banks. From the conclusion we can clearly know that there is a positive impact on among performance of the various banks taken for the study.

**OBJECTIVE OF THE STUDY**

- A study on the relationship between financial leverage and financial performance of small financial banks in India.
- An analysis of the impact of financial leverage on the financial performance of small financial banks in India.

**HYPOTHESIS OF THE STUDY**

- There is no relationship between financial leverage and financial performance of small financial banks in India.
- There is no impact of financial leverage on financial performance of small financial banks in India.

**RESEARCH METHODOLOGY**

The study's major goal is to examine SFBs (small finance banks) in India's financial leverage and performance. The approach used in this study was examined in light of the findings of other studies on the same subject. This relationship has been highlighted in other research, thus the abstract framework of this study is based on deductive techniques and quantitative approaches to collect data from secondary sources. The objectives were derived using a methodology that primarily examined the banks' levels of performance. The information was gathered via the PROWESS CMIE database, several small finance bank annual reports, and various bank websites. Below are the factors that were used in this investigation. The variables used for this study are mentioned below. The population of this study was conducted using six different small finance banks in India. The selected banks are Capital Small Finance Bank Ltd, Equitas Small Finance Bank Ltd, ESAF Small Finance Bank Ltd, North East Small Finance Bank Ltd, Suryoday Small Finance Bank Ltd, and Ujjivan Small Finance Bank Ltd.

**Analysis and Interpretation**

**Correlation**

**Table 1**

| | | ROA | ROE | DR | DER | ICR | CCR |
|---|---|---|---|---|---|---|---|
| ROA | Pearson Correlation | 1 | .816* | .174 | .888* | .992** | .628 |
| | Sig. (1-tailed) | | .046 | .390 | .022 | .000 | .128 |
| | N | 5 | 5 | 5 | 5 | 5 | 5 |
| ROA | Pearson Correlation | .816* | 1 | -.133 | .625 | -.715 | .676 |
| | Sig. (1-tailed) | .046 | | .415 | .130 | .087 | .105 |
| | N | 5 | 5 | 5 | 5 | 5 | 5 |
| DR | Pearson Correlation | .174 | -.133 | 1 | .846* | -.950** | -.629 |
| | Sig. (1-tailed) | .390 | .415 | | .035 | .007 | .128 |
| | N | 5 | 5 | 5 | 5 | 5 | 5 |
| DER | Pearson Correlation | .612 | .245 | .846* | 1 | -.644 | -.128 |
| | Sig. (1-tailed) | .136 | .345 | .035 | | .120 | .419 |
| | N | 5 | 5 | 5 | 5 | 5 | 5 |
| ICR | Pearson Correlation | .103 | .379 | -.950** | -.644 | 1 | .826* |
| | Sig. (1-tailed) | .434 | .265 | .007 | .120 | | .042 |
| | N | 5 | 5 | 5 | 5 | 5 | 5 |
| CCR | Pearson Correlation | .628 | .676 | -.629 | -.128 | .826* | 1 |
| | Sig. (1-tailed) | .128 | .105 | .128 | .419 | .042 | |
| | N | 5 | 5 | 5 | 5 | 5 | 5 |

*. Correlation is significant at the 0.05 level (1-tailed).

**. Correlation is significant at the 0.01 level (1-tailed).

The above table shows the correlation between Financial Leverage and profitability of Small financial Bank. There is a positive relationship between financial leverage and profitability. It is also observed that ROA is positively correlated with DR, DER, ICR and CCR. When they are compared to financial leverage, ROA is highly positively correlated with ICR (.992). It is inferred that the less financial Leverage positively increases the profitability of the company during the study period.

Regression

Table 2

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .999[a] | .999 | .994 | .4891127 |

a. Predictors: (Constant), DR, DER, ICR

The above table shows model for the impact of financial leverage on profitability (ROA).model 1 R square value is 99.9% in which DR, DER and ICR is considered as independent variable.

Table 3

**ANOVA[a]**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| | Regression | 171.645 | 3 | 57.215 | 239.162 | .047[b] |
| 1 | Residual | .239 | 1 | .239 | | |
| | Total | 171.884 | 4 | | | |

a. Dependent Variable: ROA

b. Predictors: (Constant), DR, DER, ICR

The above table shows the ANOVA for **Small Financial Bank of India** for the study period of 2017 to 2021.The significant value for the above model is less than 0.05.Hence the above model Is fit for determining the profitability position of the company.

Table 4

**Coefficients[a]**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | 45.514 | 1.279 | | 35.598 | .018 |
| | DER | -11.014 | .607 | -.852 | -18.147 | .035 |
| | ICR | 16.293 | 1.269 | .720 | 12.844 | .049 |
| | DR | -.018 | .001 | -1.415 | -24.776 | .026 |

a. Dependent Variable: ROA, DR, DER, ICRA

ROA = 45.514-11.014 DER+16.293 ICR-.018 DR

Table 5

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .989[a] | .998 | .993 | .23141 |

a. Predictors: (Constant), DR, DER, CCR

The above table shows model for the impact of financial leverage on profitability (ROE).model 2 R square value is 98.9% in which DR, DER and CCR is considered as independent variable.

Table 6

**ANOVA[a]**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 29.113 | 3 | 9.704 | 404.315 | .037[b] |
| | Residual | .024 | 1 | .024 | | |
| | Total | 29.137 | 4 | | | |

a. Dependent Variable: ROE

b. Predictors: (Constant), DR, DER, CCR

The above table shows the ANOVA for **Small Financial Bank of India** for the study period of 2017 to 2021.The significant value for the above model is less than 0.05.Hence the above model is fit for determining the profitability position of the company.

Table 7

**Coefficients[a]**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | 17.594 | .259 | | 67.882 | .009 |
| | DR | -.592 | .099 | -.176 | -5.975 | .106 |
| | DER | 2.253 | .086 | 1.035 | 26.184 | .024 |
| | CCR | -1.003 | .382 | -.106 | -2.625 | .232 |

a. Dependent Variable: ROE

ROE = 17.594-.592 DR+2.253 DER-1.003 ICR

**Conclusions**

This study observes the effect of independent variables: debt ratio, debt-equity ratio, interest coverage ratio, and cash coverage ratio. This study uses 6 banks listed on the small financial Bank during the period 2017 - 2021. After directing analysis and discussion, it can be concluded that the debt ratio has a positive and significant effect on ROA and ROE. The debt-equity ratio has a positive and significant effect on ROA. However, it has a positive and significant effect on ROE. The interest coverage ratio does not affect ROA, and the cash coverage ratio does not affect ROE. This study faces several confines, namely limited to the small financial bank limited to independent variables, namely debt ratio, debt-equity ratio, interest coverage ratio, and cash coverage ratio to the dependent variable return on assets and return on equity.

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