ANALYZING THE RELATIONSHIPS BETWEEN CAPITAL STRUCTURE AND BANK'S SPECIFIC FACTORS : EVIDENCE FROM MALAYSIA

BY
NOOR AZWA BINTI IDRIS

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ABSTRACT

The purpose of this study is to examine the relationships of capital structure determinants against the leverage ratio and the capital structure approach adopted by all eight (8) domestic commercial banking institutions in Malaysia.

Correlation analysis is deployed to analyse the data collected from the financial statements of the domestic commercial banks in Malaysia as of January 2016. Seven variables, i.e. leverage, profitability, tangibility, size, growth, dividend and liquidity, are studied over a five-year period.

Results show that the leverage ratio is in direct relationship with profitability, growth and liquidity, whilst in indirect relationship with tangibility, size and dividend pay-out. This concludes that highly profitable banks, banks with high potential growth and high liquidity prefer debt over equity capital while larger banks, banks with high tangible assets and higher dividend pay-out ratio prefer equity over debt capital. It is further observed that all banks under review relied more on debt rather than equity capital, with Malayan Banking Berhad, the largest domestic commercial bank in Malaysia maintain the lowest leverage ratio for the entire review period.

The writer recommends that the stakeholders of commercial banking sector in Malaysia, i.e. investors, shareholders, bank's management, lenders and policy makers, would have better understanding on the factors which may influence the capital structure of the domestic commercial banks in Malaysia, and take benefit from the findings observed in making informed decision to their interest and advantage and to enhance competitiveness in Malaysian banking sector.

Keywords capital structure, commercial banks, leverage, debt capital, equity capital

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INTRODUCTION

1.1 Background of Study

The most vital decisions to be made by the finance manager of any corporate entity is to determine the capital structure for the entity (Pastory et. al., 2013). Pandey (2010) described capital structure as the diverse method of financing a firm, i.e. the most reasonable proportion of debt and equity. Capital structure is a substantial managerial decision since it has significant impact to the shareholder's risk and return, as the share price may be affected by the capital structure decisions (Pandey, 2010). For managers, the importance of having strategic capital structure (Saad, 2010) is due to the long term effect it has on the performance of the company (Watson and Head, 2007). In addition, capital structure decision could directly influences the entity's earnings as the firm can receive constant funds from various means, including capital and debentures (Amjad et. al., 2013).

A company's capital structure comprises of the combination of preferred shares, debt and equity. This demonstrates the capital of the company which will be used to fund the business in the long run (Pastory et. al., 2013 and Amjad et. al., 2013). Other form of capital structure include the retained earnings from the profit earned from business activities (Anarfo, 2015 and Amjad et. al., 2013). The retained profit is the owner's funds which also a form of business reinvestment, and it is available to the business in long-term. Capital structure is significant in a company and therefore, determining the optimum level of debt and equity is an ongoing issue being discussed in literature related to financial areas. The information on capital

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