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Effect of Profitability and Financial leverage on Capital Structure in Pakistan Commercial Banks

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Abstract

Commercial banks show dynamic role in economy of Pakistan. Our study aim overdue, to check the impact of Profitability and Financial leverage on Capital Structure in Pakistan commercial banks. On this study have been data taken from State bank of Pakistan from the year of 2007-2015 of sixteen commercial banks. We have casually mixture of commercial banks. Our interception on behalf of descriptive statistics, covariance analysis and regression model. We reported that these two independent variables of PFT have insignificant and FLG have positive influence on capital structure.

Key Words: *Commercial Banks, Profitability, Financial leverage, Capital Structure Determinants.*

Introduction

In current history, Commercial institutions playing a Vital Role in Pakistan's Economy. Moreover Commercial Banks have faced an animated aggressive, environment at national and international levels. One of the most growing magnitudes is the new model of Islamic Banking that has remarkably paying attention of both Islamic and conventional economists. Today Islamic banks are operating in all areas of the world, and are appear to be a convenient and realistic alternative system, which has different things in attendance. Although this is originally developed to bring about the Religious needs of Muslims people, at present Islamic banking has currently achieved worldwide. Acceptance Islamic banking is recognized as one of the utmost mounting areas in Banking and Finance.

There are Commercial Banks working in Pakistan, and on the other hand different Pakistani banks are working in foreign countries, like UBL, MCB, HBL and some other banks having their branches in Middle East and also some European Countries. Some of the overseas Commercial Banks working in Pakistan like, Citi Bank N.A, HSBC Middle East Bank

Barcclays Bank, Industrial and commercial Bank of China funding is indispensable component of management, mounting and get your hands on any dealing and needed for achieve deliberate strategy. Each and every one Financial Organization and other sectors of financial system necessitate resources to financing their material goods. At hand be dissimilar traditions for elevate capital and financing the trade & industry. The fundamental behaviors for bring together funds are issue share and receiving the amounts of overdue or debts. Sixteen Commercial Banks have been chosen by us in this paper which has been listed in Pakistan Stock Exchange, the phase is used from the year 2007 to the year 2015.

In our Topic we have protect the "Effects of profitability" and "financial leverage" on the Capital Structure" in "Pakistan Commercial Banks". Textile sector is one of the biggest manufacturing industries in Pakistan. It plays a major role in economy of Pakistan. Capital Structure is the combination of Debts and Equity amounts used by different firms, Banks, Business etc. The more the debts used by any firm can make him more risky and it can cause to sufferer the shareholder from losses. Debt and Equity will have been used in our paper for measuring the "Capital Structure" of Banking Firms. The relation of Business Earnings from Business Assets is called Profitability, these are interlinked. Profitability/Effectiveness is deliberated by gross earnings before the taxes are calculated to the complete amount of assets.

According to the "Packing Order Theory" firms may boost their "Profitability" by means of their internal finances. About "Profitability There is two different theories which have added their share in this regard:

The 'Trade off Theory' and the 'Pecking Order Theory'

According to first theory which is "Trade of theory" declare that due to Debts using a firm can increase its 'profitability,. On the other hand as per Trade off Theory there is encouraging affiliation surrounded by profitability and leverage. Due to increase in amount overdue profitability also increases and to reverse this process it causes to decrease. "Pecking order hypothesis (Mayers, 1977) says that administrators have been enhanced information in relation to their companionship future than unknown and they can be able to defend or safeguard the interest of accessible investors. They said that they can bring into play retained earnings and if not possible then they can prefer debts over equities (Portaa et al., 2000; Sunder & "Myers, 1999)."

The concept of Leverage is used to boost up something, like levering something upward, whereas financial Leverage is used by different organizations and firms, and in our topic specified to the Commercial Banks the amount of "Loans or Debts" for financing the business assets. We have measured the 'Financial leverage' by dividing the debts of a firm to total assets. At above discussion the 'Capital Structure' as a dependent variable while Profitability, financial leverage, as an independent variables which are rare used.
Has Debts affected on capital structure?

Has a profitability influence on capital structure?
Has a relation among profitability and debts?

How can commercial banks enhance their market value, commercial banks helps the SEM's to make business stress-free to manage the financial. Our determination of this study to develop the economy and invention factor that influence on that profitability.

Literature Review

In "1958" "Millars & Modgliani have worked on the capital structure. By the commencement of new period in "Corporate Finance". Capital Structure theory also known to be as MM "Capital Theory:" The Theory of structure irrelevance in 1958, narrates that 'under no tax and transactions Costs" the capital cost and the firms value could not enhanced as a result of enhancement in leverages" "Modigliani and Miller's (1958). Afterwards, latest achievements were presented by Millar and Modigliani in (1963) that "cost of capital structure and capital effect, and therefore consequence the worth of the companies by paying no attention to the impractical postulations and making an allowance for that taxes exist, which point toward that borrowing provide tax benefit, while the mark up calculated from the tax will consequence tax safeguards, while dropping the expenditure of lending and take full advantage of the firm's performances" (Miller. "1977).

Accordance to Haries, Raviy 1990, he found that debt mechanism a 'Capital Structure' agrees to shareholder toward correction by organization reduce mandatory power of management's (free cash flow of firm Jensens 1986). So the shareholder takes action while it may be suffer from loss or gain. During 1995 "Kensington" scrutinize the determinants of Banks capital structure of "Australian trading banks" during period 1967 to 1988. He found little confirmation hold up trade-off between tax benefit/bankruptcy costs; while facts is generally dependable with the prediction of POT in the presence of transactions costs and asymmetric information. Kensington observed that "institutional factors" together with depository deregulation and category of bank, are momentous determinants of capital administration of "Australian trading banks".

In the manuscript (Filipovic, 2005) has investigated the conclusions & the manipulation of privatization on the swiftness of monetary augmentation, optimistic by thought of community responding to reimbursements. A sample of ninety under developed nations is used for this study. Analysis of privatization suggests that incentives allow a major role in the potential achievement of privatizations as a characteristic of economic development. In actuality privatization, go together with suitable structural reorganization, create remuneration to advancement "economic competence", "boost investment", and adopt "latest technologies".

"Habibu Sufi "2010" empirically calculated the efficiency of the "banking sector" of "Thailand" for period from 1999-2008. Using D.E.A model and multivariate deterioration analysis founds that greater good organization stages are exposed by reservoirs with "superior capitalization and higher loans intensity". Degar Alpher 2011 investigated that in-external cause of Turkish banks profitability. On his study (Return on Assets, Return on equity) has independent variable. He found that whenever (Assets size and non interest in increase) the profitability of commercial bank's will enhance. There is positive effect on (Per Share Earning) at real interest of external element. On the measuring the performance of bank 'Profitability' is determine. Javiad at al 2011 which used pooled OLS method to observe (deposit, loan, equity and assets) of a key 'Profitability' sign of return on assets of ten banks for year 2004 to 2008. He found that variable have solid effect on profitability, the major emphasis on internal factor's. His conclusion that more assets did not represented more profits in line for diseconomies of scales. The higher debts ratio did not generate to profitability significant. So on profitability substantial deposit and equity.

'Dr. Srinivas Madishetti et.al' (2013) examine the profitability factors of Tanzania commercial banks for the period of 2006-2012. This study used variables like liquidity risk, operating efficiency and credit risk, external factor influence Gross Domestic Products growing rate which are independents. This study describes that internal factor influence bank profitability but external did not. "Abuzar" 2013 suggested that factor influence Islamic bank in Suddan. On his study conclude that only profitability affect from the internal factors. Commercial banks profitability has positive relation among liquidity, size and cost. On commercial banks 'Macroeconomic' has no significant influence of commercial banks. Hassan et al 2016 found the relation among these variables, our study we are used the based equation and model to find the relation of these variable implication on commercial banks.

Methodology

Our panel data concealment the years of 2007-2015 of sixteen commercial bank's listed in Pakistan. We have taken out the data of 'Financial Statement' from commercial banks. We are take the profitability, financial leverage as dependent and capital structure independent.

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Name of Banks

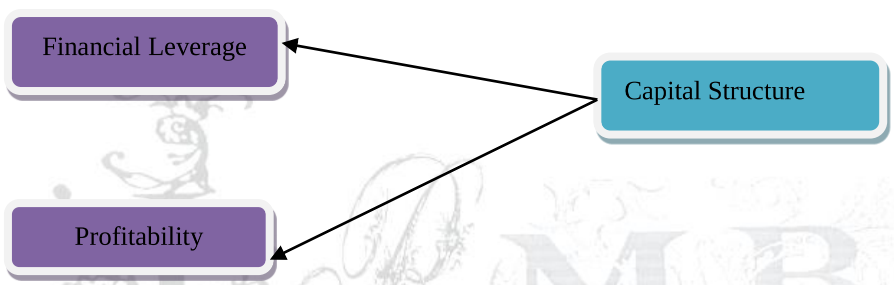
Allied bank	Aalfalah Bank	Habib Bank	JS Bank
MCB Bank	Meezan Bank	National Bank	NIB Bank
SAMBA Bank	Silk Bank	Soneri Bank	Standard Chartered
Summit Bank	Bank of Khyber	The bank of Punjab	United Bank limited

Hypothesis

H1: There is native relation of profitability and debts.
H2: It has positive relation with the profitability and capital structure.
H3: Financial leverage has positive impact on capital structure.
H4: Profitability and financial leverage has positive relation.

Theoretical Framework:

Independent Variables Dependent variable



Regression Model

This model should investigate the relation among two or more variables. Our study, have used the panel data analysis which has the combine feature of time (series, cross-sectional).
Equation:

$$\mathbf{CPS} = \boldsymbol{\beta_o} + \boldsymbol{\beta_1}\mathbf{PFT} + \boldsymbol{\beta_2}\,\mathbf{FLG} + \in$$

CPS = 'Capital Structure'
PFT = 'Profitability'
FLG = 'Financial Leverage'
$\in$ = The error term
β_o= The intercept of equation
β_1= The change of co-efficient for 'PFT'
β_2= The change of co-efficient for 'FLG'

Descriptive Statistics

Table A represent the descriptive result that the mean and median is respectively CPS is 11.71, 9.78 of Pakistani commercial banks, which minimum value and maximum while Std Dev is as shown did not close to the mean value. Respectively result represents the FLG and CPS on table A. During the study period FLG mean, median, mini, max, Std. Dev is 0.89, 0.91, 0.98, 0.65, 0.06 Std. Dev is low is show data is extremely disseminated. PTF mean and Std. Dev are closed which organized that profitability higher on capital structure.

Table A

	CPS	FLG	PFT
Mean	11.71436	0.894749	5.734153
Median	9.782750	0.911150	2.545000
Maximum	61.47570	0.987700	24.39000
Minimum	1.873400	0.652200	0.004000
Std. Dev.	8.929834	0.064087	6.800601
Skewness	2.623612	-1.292783	1.395474
Kurtosis	11.97760	5.023051	3.816471
Jarque-Bera	648.7839	64.66734	50.73609
Probability	0.000000	0.000000	0.000000
Sum	1686.868	128.8439	825.7180
Sum Sq. Dev.	11403.10	0.587315	6613.489
Observations	144	144	144

Correlation of Coefficient

On this study for a find a relationship is used the correlation analysis. On above discussion results conclude that there is solid positive relation with the CPS to FLG. There is minor positive almost zero relation with the CPS to PFT. But this relation with CPS and PFT is (minor) positive most weakly relationship. Correlation of PFT and debts is also sign of the positive relation.

Covariance Analysis: Ordinary

Sample: 1 144
Included observations: 144

Table B

Correlation	CPS	FLG	PFT
CPS	1.000000		
FLG	0.609871	1.000000	
PFT	0.024230	0.079298	1.000000

Regression Analysis

A selection of this model on behalf of bank's capital structure on the base of higher R Squared. Table C represent the regression analysis. R squared vale is 0.37 mean 37% variation of independent variable and which results 67% did not described. The F value is 41 which is significant show the model is good fit in our study. Regression analysis reported Prob that financial leverage has a confidently significant effect on capital structure, while the profitability has insignificant. Co-efficient suggests that profitability has inverse relation, capital structure increase while profitability decreases. Durbin Watson vale is 2.051 which show that there is no auto-correlation. Syaafri 2012 reported that there is positive relationship with the profitability and debts. Riaatb at al suggested that if commercial banks internal financing create the positive relation with the higher capitalization return more profitability. Our result rejected the H1 hypothesis that there is no negative relationship; H2 is accepted by there is positive relation with capital structure and profitability but minor. H3 is also accepted assumption there is positive relation with them, H4 has a recognized that true depicted of result which valid result. Bruce et al 2013 reported that banking has a impact on banks of participation of loan agency many factor influence they will decrees the performance his result is that which are positive relation.

Table C

Dependent Variable: CPS
Method: Least Squares

Sample: 1 144
Included observations: 144

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-64.37817	8.339608	-7.719568	0.0000
FLG	85.24777	9.324657	9.142188	0.0000
PFT	-0.031887	0.087873	-0.362880	0.7172

R-squared	0.372529	Mean dependent var	11.71436
Adjusted R-squared	0.363629	S.D. dependent var	8.929834
S.E. of regression	7.123587	Akaike info criterion	6.785313
Sum squared resid	7155.114	Schwarz criterion	6.847184
Log likelihood	-485.5425	Hannan-Quinn criter.	6.810454
F-statistic	41.85576	Durbin-Watson stat	2.051533
Prob(F-statistic)	0.000000		

Conclusion and Recommendation

After all results and above discussion, we conclude that our study model and variable have significant relation and they effect on capital structure in Pakistan commercial banks. Previous research sustained this study, have a positive support.

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