CHAPTER 5

COST OF CAPITAL AND CAPITAL STRUCTURE IN BANKS
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CHAPTER 5

COST OF CAPITAL AND CAPITAL STRUCTURE IN BANKS

A well-conceived capital structure is absolutely necessary for achieving the bank’s objectives and the determination of cost of capital. Against this backdrop an in-depth analysis is made of the economic conditions of the banks in Kerala which would give an insight into the strength of these banks.

5.1 Pattern of Capital Structure of the Four banks

The capital structure represents the kinds and proportion of securities issued to raise the total amount.

Table T 78:
Pattern of Capital Structure of Four Banks

<table>
<thead>
<tr>
<th>Year</th>
<th>CSB</th>
<th>608181.15</th>
<th>1331639.24</th>
<th>557263.82</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997-1998</td>
<td>195111.11</td>
<td>1331639.24</td>
<td>557263.82</td>
<td></td>
</tr>
<tr>
<td>1998-1999</td>
<td>441920.82</td>
<td>705306.29</td>
<td>2497229.54</td>
<td>1209440.50</td>
</tr>
<tr>
<td>1999-2000</td>
<td>688730.53</td>
<td>802431.44</td>
<td>3662819.84</td>
<td>1861617.19</td>
</tr>
<tr>
<td>2000-2001</td>
<td>935540.24</td>
<td>899556.58</td>
<td>4828410.15</td>
<td>2513793.87</td>
</tr>
<tr>
<td>2001-2002</td>
<td>1182349.95</td>
<td>996681.73</td>
<td>5994000.45</td>
<td>3165970.56</td>
</tr>
<tr>
<td>2002-2003</td>
<td>1429159.65</td>
<td>1093806.87</td>
<td>7159590.75</td>
<td>3818147.24</td>
</tr>
<tr>
<td>2003-2004</td>
<td>1675969.36</td>
<td>1190932.02</td>
<td>8325181.05</td>
<td>4470323.93</td>
</tr>
<tr>
<td>2004-2005</td>
<td>1922779.07</td>
<td>1288057.16</td>
<td>9490771.36</td>
<td>5122500.61</td>
</tr>
<tr>
<td>2005-2006</td>
<td>2169588.78</td>
<td>1385182.31</td>
<td>10656361.66</td>
<td>5774677.30</td>
</tr>
<tr>
<td>2006-2007</td>
<td>2416398.49</td>
<td>1482307.45</td>
<td>11821951.96</td>
<td>6426853.98</td>
</tr>
</tbody>
</table>
Table-T 78 shows that all the banks include only the equity shares and reserves and surplus in the capital structure. The table reveals that all the banks increased their pattern of capital structure for the ten years. The highest shown by all the banks were in the year 2006-2007 (Fig-F 122).

![Pattern of Capital Structure of Four Banks]

**Fig. F 122:** Pattern of Capital Structure of Four Banks

### 5.2 Optimum Capital Structure

The Return on Investment is more than the cost of borrowings, each rupee of extra borrowings pushes up the earnings per equity share, which in turns increase the market value of the share. It is found in the study that, the financial managers of the banks considered the element of
capital structure i.e., to decide the proportion of ownership funds and borrowed funds.

5.3 Achieving the Optimum Capital Structure

Optimum capital structure can be achieved when the value of equity share is maximum while the average cost of capital is minimum.

![Graph showing capital structure]

**Fig. F 123:** Achieve the Optimum Capital Structure

From the review of relevant literature all the banks under study attained the optimum capital structure by using an ideal combination of owned capital and Reserves and Surplus (Fig-F 123).

5.4 Features of an Appropriate Capital Structure

The principles regarding an appropriate capital structure are, as a matter of fact, militant to each other. After the review of relevant literature, it is
found that raising of funds through debt is cheaper and, is therefore, in accordance with the principal of profitability, but it is risky and, therefore, goes against the principle of solvency and conservatism.

![Fig. F 124: Features of an Appropriate Capital Structure](image)

It is very clear from the above Fig-F 124 that the Dhanalakshmi Bank and the South Indian Bank consider the profitability and control as the appropriate features of capital structure. But in the case of the Federal Bank, five features for a capital structure are considered to be appropriate.

**5.5 Factors Determining the Capital Structure**

The capital structure of the bank was determined at the time of floatation. Of course, it is not possible to have an ideal capital structure
but the management should set a target capital structure and the initial capital structure should be framed and subsequent changes in the capital structure should be done keeping in view the target capital structure. Thus, the capital structure decision is a continuous one and has to be taken when ever the bank needs additional finances.

**Fig. F 125:** Factors determining the Capital Structure

The Fig-F 125 shows the various factors of the four banks for determining the capital structure. All the banks give equal importance for trading on equity and RBI guidelines on any financial matters of bank.
5.6 Cost of Capital

The cost of capital is a very important factor in formulating a bank’s capital structure.

\[
\text{Fig. F 126: Cost of Capital}
\]

All the banks under study gave due consideration for the cost of capital (Fig-F 126).

5.7 Importance of Cost of Capital

The determination of the bank’s cost of capital is important from the point of view of both capital budgeting as well as capital structure planning decisions.
From the analysis it is found that the Catholic Syrian Bank and the Dhanalakshmi bank consider only one factor, capital budgeting decisions. But the other two banks consider the two factors for the determination of cost of capital such as capital budgeting decisions and capital structure decisions (Fig-F 127).

5.8 Classifications of Cost of Capital

The classification of cost of capital is different in all the banks under study.

Fig. F 128: Classifications of Cost of Capital
The study reveals that classifications of cost of capital have a paramount importance for the determination of the cost of capital. The Catholic Syrian Bank takes into account the implicit cost, average cost and marginal cost for the determination of cost of capital. Historical cost is the only classification of the Dhanalakshmi bank. But in the case of the Federal bank historical cost, average cost and marginal cost were included (Fig-F 128).

5.9 Problems faced on Computation of Cost of Capital

The cost of capital is one of the most crucial factors in most financial management decisions. The top management is confronted with large number of problems, both conceptual and practical, while determining the cost of capital of a bank.

Fig. F 129: Problems faced on Computation of Cost of Capital
From the review of relevant literature of the four banks these problems are different in each case. The Federal Bank faces five problems on computation of cost of capital. But in the case of the South Indian Bank, they face two problems i.e., computation of cost of capital and computation of cost of retained earnings and depreciation funds (Fig-F 129).