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Capital Structure and Financial Performance of Commercial Banks in Ibanda District.

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CHAPTER ONE
INTRODUCTION

I. INTRODUCTION

An appropriate capital structure is a critical decision for any business organization. The decision is important not only because of the need to maximize returns to various organizational constituencies, but also because of the impact such a decision has on an organization's ability to deal with its competitive environment. Capital structure refers to the composition of firm's financial resources. These funds are required for carrying on the business and are a major determinant on how the business operates hence their availability and quantity is critical to the firm (Boubaker, Rouatbi & Saffar, 2017). Commercial banks operate in a world of stiff competition and cost effective mix of capital is an important decision for them to survive this competition and sustain their operations into the future. In the wake of the recent global financial crisis commercial banks have been placed under the spotlight and their capital adequacy levels and capital structure have come into question. The choice of alternative funding sources and the resultant mix of debt to equity are of utmost importance to bank management. Bank management is constantly in search of an optimal capital structure that maximizes the value of the firm and decreases its risk profile (Fareed et al., 2014). Thus this study will establish the relationship between capital structure and financial performance of financial institutions. In this study, capital structure is the independent variable operationalized in terms of short term debt financing, long term debt financing and retained earnings while financial performance is the dependent variable measured in terms of Profitability, Liquidity, Loan portfolio quality , Return on Investment and Growth of assets. This chapter presents the background to the study, statement of the problem, purpose of the study, specific objectives, research questions, scope of the study, significance of the study, conceptual frame work and operational definition of terms.

1.1 Background to the study

1.1.1 Historical Background

Poor financial performance has been at the heart of many commercial banks failures around the globe and this has seen the collapse of several commercial banks worldwide. The most well-known include; Northern Rock (United Kingdom), Anglo Irish Bank (Ireland), Scottish bank (Scotland), Twiga Bancorp (Tanzania), Imperial Bank and Chase Bank (Kenya), Crane Bank Ltd (Uganda) among others. Therefore the financial performance of the banking sector is a key to the health of the banking sector and is closely linked to the safety of the entire economy in general. Sharma & Mani (2012) points out that the bank's financial performance has become a point of concern to policy makers and other economic agents due to the fact that the realistic gains of a country's economic sector largely depend on the efficiency of the banks in carrying out their function of financial intermediation. Banks mobilize savings from surplus economic units to deficit economic units and also mobilize funds between depositors and borrowers.

As a result, Commercial banks in developing countries have consistently continued strive to build their banking sector over the years however, lack of adequate capital in terms of debt and equity often impede their financial performance(Zaroki & Rouhi (2015). Due to this constraint, commercial banks strive to ensure they combine available debt and equity in an optimal manner that can guarantee the maximization of financial performance. This suggests that capital structure can affect bank's financial performance (Musah, 2017). Capital structure decision is therefore vital one since the financial performance of a bank is directly affected by such decision.

Brounen and Eichholtz, (2001) depict that making a decision on the appropriate capital structure of an entity is among the most confusing aspects in the modern corporate finance. According to Pastory, Marobhe and Kaaya (2013), capital structure decision is crucial for any entity due to the fact that the stewards (managers) have a responsibility to make sure that the return to shareholders is maximized and because decisions of this nature have tremendous consequences on the ability of the entity to compete. Therefore, this decision on the ratio of total debt to equity is considered as a strategic one for managers i.e. future oriented and has a long term effect (Pastory, Marobhe and Kaaya, 2013).

Azhagaiah and Gavoury(2011) portray that the best alternative is a debt and equity mix. Owners would not be sure as to which source of financing to use if interest was not tax deductible. However, if interest was tax deductible, then managers would maximize the firm's financial performance by using debt financing only. But this is not possible due to the fact that debt finance increases the potential bankruptcy costs and agency costs i.e. costs which arise due to the relationships between shareholders and managers, and those between debt-holders and shareholders.

Goyal (2013) narrated that the choice of financing is a reflection of an effort by corporate managers to make sure that there is a balance between tax shield of higher debt and the potential high cost of financial distress caused by under investment. The use of more debt is likely to destroy firm's value, because it results in financial distress and under investment however, the use of less debt may also destroy firm's value due to overinvestment which may affect profits.

Flannery and Rangan (2008) document that in the 1990s, large banks in the United States increased their capital well above the regulatory minimum. It is widely assumed in the banking literature that equity is a costly form of finance for banks and other financial institutions (Flannery and Rangan, 2008). This suggests that banks should minimize the amount of capital they use, and if there is a regulatory minimum, this should be binding. However, in practice, this is not the case.

Berger and Di Patti (2006), using data on commercial banks in the USA found that higher leverage or lower equity capital ratio is related to higher financial performance. At some point where bankruptcy and distress become more likely, the agency costs of outside debt overwhelm the agency cost of outside equity, and therefore further increases in leverage lead to higher total agency cost of outside debt from risk shifting or reduced effort to control risk that result in low financial performance.

According to Kyereboah and Coleman (2007) agency costs due to conflict of interest between shareholders and management lead to higher interest expenses from firms to be able to compensate debt holders for their expected losses. Thus, capital structure which is defined as total debt to total assets at book value, impacts on both the profitability and riskiness of a firm. Therefore, the structure of a firm's capital has implications for its operations and affects its financial performance. Awunyo-Vitor and Badu (2012) made an observation that the average capital structure of the listed Banks on the Ghana Stock exchange was 87% from 2000 to 2010 implying the banks listed on the Exchange are highly geared. The high level of gearing observed was that the banks financial performance can be attributed to their over dependency on short term debt.

Commercial banking in Uganda started before Uganda's independence in 1962, where government-owned institutions dominated most banking in Uganda. In 1966, the Bank of Uganda (BoU), which controlled the issue of currency and managed foreign exchange reserves, became the central bank and national banking regulator. Uganda Commercial Bank, which had fifty branches throughout the country, dominated commercial banking and was wholly owned by the government (Uganda Banking, 2014). In the 1960s, other commercial banks included local operations of the Bank of Baroda, Barclays Bank, the Bank of India, Grindlays Bank, Standard Chartered Bank, and the Uganda Cooperative Bank. During the 1970s and early 1980s, the number of commercial bank branches and services contracted significantly (Uganda Banking, 2014).

Banks' performance in Uganda has deteriorated in the past years in the form of increased loan defaults and closure of some banks. In 2012, Bank of Uganda closed down National Bank of Commerce, a local commercial bank owned by private domestic investors. Its deposits were liquidated to Crane Bank, under the directive and control of the Bank of Uganda (Rupiny, 2012). More so, the sector in Uganda has gone through a series of revolutions especially in early 2000; it experienced restructuring as several local commercial banks were publicly declared insolvent, taken by Bank of Uganda and finally liquidated. These included the Uganda Cooperative Bank, Greenland Bank, the International Credit Bank, Teefe Bank, Nile bank and Gold Trust Bank (Juuko, 2007). This resulted in the passing of 2004 legislative bill which got enacted and termed as "The Financial Institutions Act 2004" upon financial institutions composed of governance and compliance guidelines to improve and strengthen financial sector based on principles of corporate governance, transparency and accountability. Hence in 2008–2009, several existing institutions went through a massive branch expansion either by opening up new ones or through mergers and acquisitions resulting in tremendous growth in the banking industry in Uganda.

1.1.2 Theoretical Background

This study will be anchored on irrelevance theory by Modgliani & Miller (1958) which show that under certain circumstances, the total value of the firm is independent of its capital structure, respectively debt/equity ratio, also cited by (Tanushev, 2016). The assumptions embedded in later studies MM (1961) are perfect capital market, rational behavior, information symmetry &long-term investment policy by joint stock companies also cited by (Tanushev, 2016). According to MM, in a rational economic environment in tandem with investors behavior, the investors won't really mind whether it's in the shape of cash or capital gain and there exists "perfect certainty" on behalf of investor's that they will invest and there's certainty in their returns while the market is perfect, consequently the firm value does not depend upon the dividend policy, hence irrelevant in regard to the firm value. The hypothesis resembles the Net operating income approach if taxes aren't taken into account. Modigliani and Miller, (1958) have proven that financing decisions in a perfect and frictionless market do not matter and have no material effects on the value of the firm or its cost of capital. This logic is widely accepted by academics today for example, (Mostaf & Boregowd, 2014).

However, financing can matter by changing the outside parameters. Including taxes, information problems and agency costs a somehow optimal capital structure becomes visible. All these effects have an influence on the overall level of debt vs. equity (and internal resources) a company chooses for its personal capital structure. MM and Myers, (2002) indicates that the capital structure theories and empirical studies dwell mainly on financing strategy as well as optimal debt-ratio selection for a given firm operating in a distinct environment. The same statement is proved by Miller *et al.*, (1961) in their research paper on, Dividend policy, growth and the valuation of shares.

In support of the same theory researchers like Black *et al.*,(1974) in their paper on the effects of dividend yield and dividend policy on common stocks prices and returns(black, Fischer & Myron Scholes, - journal of financial economics 1, no.1 (1974):1-22), did a research study on the impact of dividends on stock prices , their results revealed insignificant results with t-value of 0.94 , concluding that the might increase its dividends but keeping in view that it will have influence on the stock prices, and changes which may occur are temporary, as the investors become certain that the dividend increase aren't signaling any future investment prospects. Also the decrease in dividends payment for a firm with capital needs it least expensive since it won't affect stock prices and debt cost effective. It is still an academic and business related question which underlying theory does explain the practical approach more exactly, if any, consequently relevant or irrelevant in dividend policy decisions for analysis of its effects. MM theory is relevant in this study because it touches on dividend policy decisions and capital financing decisions. It affects Dividend policy, Equity and Debt finance.

1.1.2 Conceptual Background

Moyer et al., (1999) defines capital structure as how a firm finances its assets with permanent short term debt, long term debt, preferred stock and common equity. In general, firms finance only a part of their assets with equity (ordinary, preference and retained earnings) capital, while the other part is financed by other resources such as long term financial debt or liabilities (like bonds, bank loans and other loans) and other short term liabilities for example trade payables (Moyer et. al., 1999). According to Fan, Titman and Twite (2012) capital structure is defined as owners' equity and interest bearing debt including short term bank loans.

According to Abor (2005), capital structure is the mix of debt and equity that the firm uses in its operation and is a mixture of different securities. Dare and Sola (2010) refer to capital structure as the debt-equity mix of business finance which is used to represent the proportionate effect of debt and equity in corporate firms' finances. Operationally, capital structure of commercial banks include debt and equity. Debt included short term debt and long term debt. On the other hand, equity include retained earnings and share capital.

Firm performance is the ability of an organization to gain and manage the resources in several different ways to develop competitive advantage (Iswatia & Anshoria, 2007).Mwangi (2016) defines financial performance as a measure firm's efficient assets utilization from its primary mode of business and generate revenues, giving results of firm's policies and operations in monetary terms**.** Also it is the range by which objectives of the firm especially financial objectives will be met or have been met (Yahaya & Lamidi, 2015).This identifies firm's strengths and weaknesses in both horizontal and vertical analysis of financial position and income statement, for a set period mostly yearly. Financial performance can be measured by return on investment, competitive position, sales growth, cash flow, market share growth, profitability and profit improvement (Lyria *et al*., 2017). Omar (2017) firm performance measures will include both financial and non-financial measures. Financial measures can be expressed by profit, revenue, return on investment (ROI) and return on equity (ROE) and earnings per share (EPS). Return on Capital Employed it's a measurement of financial performance of company's operating division that is not responsible for its financing and income taxes (McClure, 2017).

1.1.4 Contextual Background

Although banks are different from other corporate entities, they are still faced with the similar challenge of choosing the optimal capital structure that would minimize the cost of capital and increase profits as in non-financial entities. However, it is apparent from the existing literature that many surveys are either deficient of adequate variables or the scope of study is wanting. According to surveys of Shivdasani and Zenner (2005), Kaumbuthu (2011), Shubita and Alsawalhal (2012), Yusufet al., (2014), Chistiet al., (2013), Zurigat (2009), Maina and Kodongo (2013) and Chechet and Olayiwola (2014) did not split debt into short and long term in their analysis. It would have been imperative to split debt since there is a possibility that the two contributes differently to their response variable proxies. It is also evident in all surveys that equity capital has not been separated so as to analyse in isolation the impact of retained earnings, ordinary and preference capital on financial performance.In Uganda, few studies were conducted on capital structure. These were in microfinance institutions (Sekabira, 2013), electricity generation projects (Mutyaba, 2014) but none was conducted in commercial banks. In view of the foregoing, this study therefore tries to address some of these deficiencies.

1.2 Statement of the problem

Financial performance of commercial banks in Uganda has deteriorated in the past years in the form of increased loan defaults and closure of some banks. World Bank (2022) reports a declining trend in the financial performance of commercial banks over the years as expressed in their profitability (ROE). The ROE of commercial banks stood at 21.99% as at 2012 which is a fall compared to the 23.10% of 2011. Furthermore, the declining trend in profitability extended to 2013, 2014 and 2015 as the ROE stood at 20.94%, 20.88% and 17.39% respectively (Namanya, 2019). The ROE of commercial banks in Uganda further declined in 2016 which was largely attributed to the interest rate capping bill of 2016 introduced in Uganda. This development has however taken commercial banks unexpectedly as it exerts an adverse effect their financial performance, cutting down the excess profits previously enjoyed by banks which have resulted in the downsizing of their workforce in order to cover for the operating cost which they incur (Ssekabira, 2023). Its profit after tax fell by 10.4% to Sh 6.64 Billion. Also, a fall by 10.3% which represents Sh 19.26 Billion in total interest income while a further drop by 7.2% representing Shs. 13.4Billion in net interest income (Bank of Uganda, 2023). It is upon this that the researcher is prompted to conduct a study on capital structure and financial performance of commercial banks using selected banks in Ibanda district.

1.2 General objective

To assess the relationship between capital structure and financial performance of commercial bank in Ibanda district.

1.3 Specific objectives

This study will be guided by the following objectives:

1.4. Objectives

i. To examine the effect of short-term debt financing on the financial performance of commercial banks in Ibanda district

ii. To examine the effect of long-term debt financing on the financial performance of commercial banks in Ibanda district

iii. To examine the effect of retained earnings on the financial performance of commercial banks in Ibanda district

1.5.Research questions

i. What is the effect of short-term debt financing on the financial performance of commercial banks in Ibanda district?

ii. What is the effect of long-term debt financing on the financial performance of commercial banks in Ibanda district?

iii. What is the effect of retained earnings on the financial performance of commercial banks in Ibanda district?

1.6 Scope of the study

1.6.1 Geographical scope

Geographically, this study will be conducted from commercial Banks in Ibanda branch. These banks are chosen because their financial performance has been low for the last five years which has attracted the researcher's attention to conduct this study. Commercial banks in Ibanda district and they include Stanbic bank, Centenary bank, DFCU bank, Post bank and Prime Microfinance.

1.6.2 Content scope

The study will establish the relationship between capital structure and financial performance of financial institutions. In this study, capital structure is the independent variable operationalized in terms of short term debt financing, long term debt financing and retained earnings while financial performance is the dependent variable measured in terms of Profitability, Liquidity, Loan portfolio quality , Return on Investment and Growth of assets.

1.6.3 Time scope

This researcher will utilize information for a period of 5 years from 2018 to date. This period is chosen because financial performance of financial institutions has been low for the last 10 years which has created a need to conduct this study.

1.7 Significance of the study

This study will be of great significance to the government, entrepreneurs, political leaders, the community and the general public in the following ways:

The firm's shareholders and management, this study will enlighten them on the effect of capital structure on their firm's value thus help them make informed financing decisions about debt capital that would enhance their firm's financial performance.

It will also provide corporate financial managers with information that will help them establish a financing policy on how the firm should finance their assets to maximize its value.

The government and other regulators and policy makers, the findings of this study will be useful in regard to advising and formulation of policies and guidelines that would not just govern the firms but also enhance their performance which in turn will improve the performance of the economy.

The study will also assist company policy makers in determining the optimal capital structure to maintain in their capital structure in order to maximize the company value by minimizing financing costs.

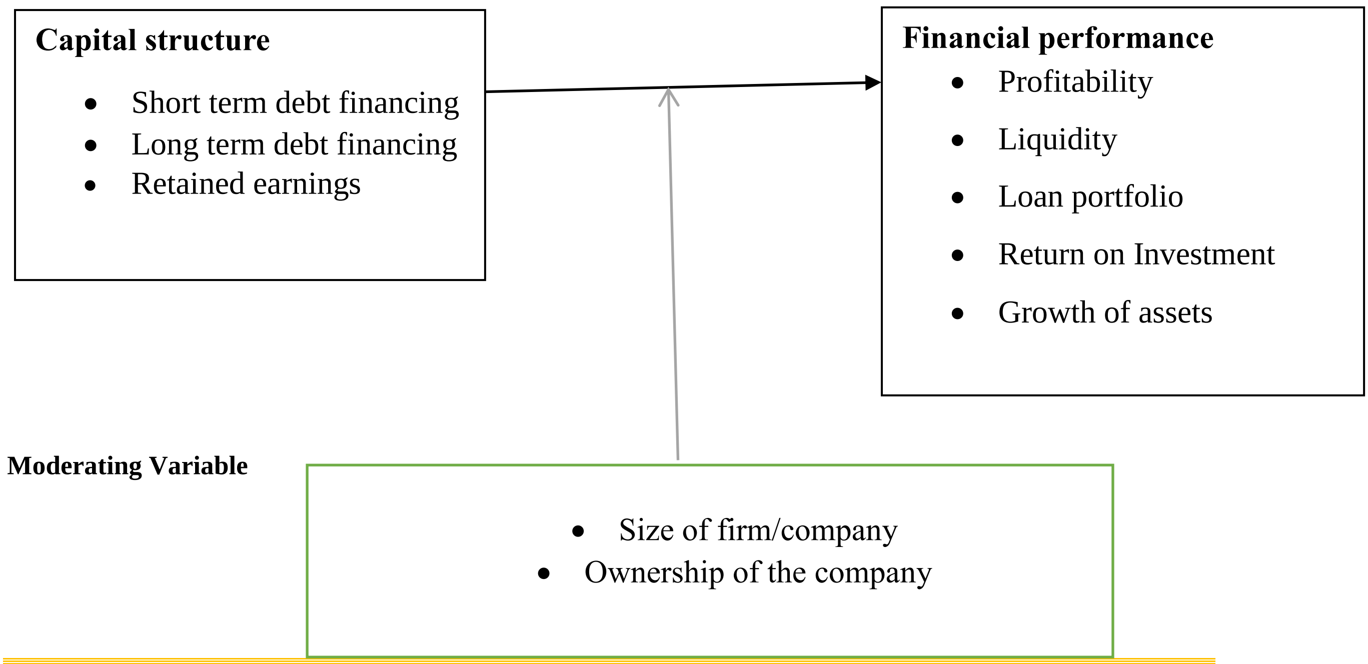
To the investors and other financiers, the study seeks to enlighten them on how capital structure affect the financial performance of firms thus help them make informed investment and lending decisions that will ensure they get a return on their investment.

To academicians and future researchers, the study will form a basis for future research by providing additional information on this particular topic.

1.8 Conceptual frame work

A conceptual framework refers to a group of concepts that are broadly defined and systematically organized to provide a focus, a rationale, and a tool for the integration, presentation and interpretation of information (Cooper and Schindler, 2006). As noted by Smyth (2004), a well-presented conceptual framework helps to explain the possible connections between the variables.

Independent Variable **Dependent Variable**



Source: Kotelnikov (2015) and modified by the researcher, 2024

In this study, capital structure is the independent variable operationalized in terms of short term debt financing, long term debt financing and retained earnings while financial performance is the dependent variable measured in terms of Profitability, Liquidity, Loan portfolio quality , Return on Investment and Growth of assets.

1.9.Definition of key terms

Capital structure is how a firm finances its overall operations and growth by using different sources of funds. A firm's capital structure can be a mixture of long-term debt, short-term debt, common equity and preferred equity.

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation.

Profitability is the ability of a business to earn a profit. A profit is what is left of the revenue a business generates after it pays all expenses directly related to the generation of the revenue, such as producing a product, and other expenses related to the conduct of the business activities.

Long-term debt consists of loans and financial obligations lasting over one year. Long-term debt includes any financing or leasing obligations that are to come due in a greater than 12-month period.

Short-term debt refers to any financial obligation that is either due within a 12month period or due within the current fiscal year.

Retained Earnings are profits not paid out as dividends but retained for financial future investment needs.

Size of the Firm/Company will matter in a way that the structure of small organization will change drastically as the size of the organization moves on from small to large.

CHAPTER TWO
II. LITERATURE REVIEW

2.0. Introduction

This chapter discusses the already existing literature about the study variables. This literature was obtained from textbooks, and publication, periodical research reports and Internet among others. The study was guided by the research objectives.

2.1. Short term debts and financial performance of commercial banks

Short-term debt, also known as short-term liabilities, refers to any financial obligation that is either due within a 12-month period or due within the current fiscal year. The value of the short-term debt account is very important when determining a company's performance. If the account is larger than the company's cash and cash equivalents, this suggests that the company may be in poor financial health and does not have enough cash to pay off its short-term debts. Short term debt financing has a maturity period of one year or less, they must be repaid quickly within 90-120 days. Maturity matching between debt and the life of assets plays an important role in deciding the length of the debt maturity (Heyman et al., 2017).

According to Benmelech and Dvir (2019), term loans with short maturities help to meet immediate need for financing without long term commitment. Benmelech and Dvir (2019) further stressed that the cost of servicing short term debt is less taxing on the company. Short term loans usually offer lower interest charges, and most lenders do not charge interest until all credit allowance period is breached. The study by El-Sayed Ebaid (2019) sought to establish the relationship between debt level and financial performance of companies listed on the Egyptian stock exchange. The study found out that there was a negative impact of short term debt on return on assets.

Teruel and Solane (2018) analyzed the Spanish SMEs and found that firms with a higher amount of short-term debt will hold higher levels of cash, because it might lower the risks of the non-renewal the short-term debt. Palombini and Nakamura (2021) in their study on debt financing suggest that aggressive liquidity policy combine the higher levels of normally lower cost short-term debt and less long-term capital. Although capital costs are reduced, this increases the risk of a short-term liquidity. They established that total and short-term debt is positively related to firm’s profitability, which might be the most important factor in accessing outside financing in countries with weak collateral laws. From their studies they also found out that a negative relation between tangibility and short-term debt and a positive relationship between tangibility and long-term debt exists.

According to Garcia-Terul and Martinez-Solano, (2017) Short-term debt is positively correlated with firm’s growth opportunities. Short-term debt is the best financing tool because it is perceived to be cheaper. According to Jun and Jen (2019) suggest several advantages of short term debt, first they suggest that short term debt adapts more easily to a firm’s financial need. Secondly it facilitates bank relations between the firm and the lender due to frequent renewals and hence firms might obtain credit condition benefits. Ozkan (2020) argues short term debt can mitigate agency conflicts between shareholders and debt holders. Empirical evidence confirms that firms can use short term debt loans to solve the problem of underinvestment because management is more frequently monitored due to periodic credit renewal.

Ideally, operating capital is available from the revenue generated by business operations. During the initial period a business is in operation, and at other times during its existence, revenue may not keep up with operational expenses (Rajan and Winton, 2021). One of the advantages of short-term debt is ensuring that cash is available to satisfy the operating capital needs of a business (Rajan and Winton, 2021). Short-term debt literally is used to keep a business running during times when the revenue stream temporarily is insufficient to meet operational needs.

Short-term debt in an environment of incomplete contracts grants the lender a control right as the firm's ability to roll over the debt may be conditioned on financial ratios and adequate performance. As this mechanism limits managerial discretion it may contribute to the relaxation of financial constraints (Rajan and Winton, 2021). This increased availability of external finance should stimulate better performance. Existence of a positive effect of leverage on firm profitability and growth in earnings is robust to also including short-term bank loans in the definition of leverage. Teruel and Solane (2018) analyzed the Spanish MEs Corporate cash holdings and find that firms with a higher amount of short-term debt will hold higher levels of cash, because it might lower the risks of the non-renewal the short-term debt.

Maturity matching between debt and the life of assets plays an important role in deciding the length of the debt maturity (Ooghe, 2017). According to Garcia-Terul and Martinez-Solano, (2017) Short-term debt is positively correlated with firm's growth opportunities. Short-term debt is the best financing tool because it is perceived to be cheaper. Thus, both entrepreneur and bank prefer short-term debt (Landier and Thesmar, 2019). According to Garcia-Terul and Martinez-Solano, (2017), few business owners start a venture with the idea that it will remain the same size into the future. Most business owners desire at least some degree of expansion. Short-term debt provides a business with ready cash to initiate an expansion program, according to "Loan Financing Guide for Small Business Owners." For example, short-term debt is used to lease additional space to house the business' growing operations.

Weinraub and Visscher (2019) in their study on debt financing suggest that aggressive liquidity policy combine the higher levels of normally lower cost short-term debt and less long-term capital. Although capital costs are reduced, this increases the risk of a short-term liquidity problem. They established that total and short-term debt is positively related to firm's profitability, which might be the most important factor in accessing outside financing in countries with weak collateral laws. From their studies they also found out that a negative relation between tangibility and short-term debt and a positive relationship between tangibility and long-term debt. These results are consistent with most theories on capital structure that suggest that firms without fixed-assets to use for collateral are unable to access long-term financing (Visscher, 2019).

According to Teruel and Solane (2018), short-term debt is positively correlated with firm's growth opportunities. The anecdotal evidence suggests that there is a positive relationship between short term debt financing and financial performance. Furthermore, it has been argued that short-term debt influences a firm's financial performance negatively, because short-term debt exposes firms to the risk of refinancing (Zeitun and Tian, 2014).

2.2. Long term debt financing and financial performance of commercial banks

Long term debt is money that is owed to lenders for a period of more than one year from the date of current balance sheet. The study by El-Sayed Ebaid (2019) found that there was no significant relationship between long term debt and return on assets. Long term debts are most preferable sources of debt financing among well-established corporate institution mostly by virtue of their asset base and collateral is a requirement many deposit taking financial institutions. According to Berger and Udell (2016), large financial banks have considerably reduced lending to SMEs thus inhibiting their potential for growth and financial performance.

Long term loans are most preferable sources of debt financing among well-established corporate institution mostly by virtue of their asset base and collateral are a requirement many deposit taking financial institutions such as industrial development banks, cooperative banks and commercial banks who grant medium term loans for a period of three to five years with an agreement on the cost (interest rate on principle amount) ,MEs in their limited asset base, have not potential of securing long term loans as a major instrument of debt financing hence giving it a major constraints in borrowing funds to finance their operations (Visscher, 2019). This in turn limits sources of financing are available to MEs. Report by European Commission (2018) indicates large financial banks have considerably reduced lending to MEs thus inhibiting their potential for growth and financial performance. For this reason alternative forms of financing get more and more important in order to reduce the dependence on the main bank.

Long-term debt limits managerial discretion by making access to new funds and over-investment less likely Hart and Moore (2020): a feature that would enhance profitability. Schiantarelli and Jaramillo (2014) argue that shorter-term loans are not conducive to greater productivity while long-term loans may lead to improvements in productivity (Schiantarelli and Srivastava (2014). It is higher in stronger and more flexible firms, when there are big differences between short term and long term interest rates and when firms have more growth opportunities (Moro, 2019). An econometric study by Hernandez-Canovas and Koeter-Kant (2018), suggests that the important variables in determining MEs long-term debt include the length of the banking relationship and the number of banks involved (Moro, 2019).

A Long term loan is a loan from a financial institution. Long term loans can be raised in relatively short period, because long term loans are negotiated directly between the lender and the borrower, and documentation is minimized (Visscher, 2019). Terms and conditions of long term loan can be revised on by mutual agreement between the lender and borrower. Long term loan has lower issuance costs. Funds raised from Long term loan are typically used to finance permanent working capital, to pay for fixed assets or to discharge other loans a firm had borrowed (Athreya, 2018).

Long term loans minimize time spent saving for investments and investors are able to realize potential earnings sooner to help offset the cost. Long term loans increase the flexibility of an investor's limited capital by allowing for its distribution over multiple investments, and minimizing the immediate impact on operational cash flow (Athreya, 2018). Long term loans provide an opportunity to finance potential investments while maintaining control of the firm.

Generally, long term loans have a very structured payment thus builds credit. It can be very advantageous to take out a long term loan for a business. After the maturity date and when full ownership is assumed, the former debtor and now owner can use the asset and the positive credit they have developed paying for it for future borrowing (Athreya, 2018). Thus, reliable debtors experience a compounding effect of the advantages of a long term loan.

According to Hammes (2019), he examined the relationship between long term loan and performance by comparing Polish and Hungarian firms to a large sample of firms in industrialized countries. He used panel data analysis to investigate the relation between long term loan financing, and firms‟ performance measured by profitability. His results showed a significant and negative effect for most countries. According to Abu (2021), He examined Capital structure and firm performance; Evidence from Palestine stock exchange" and found negative adjusted R square value of - 0. 302 existed between long terms loans and bank performance as measured by ROA. Asterbro and Bernhardt (2019) researched on Start-up Financing, Owner Characteristics, and firm performance of French firms. They found long term loan financing explained 4.787% variability in ROA and 1.14% variability in ROE.

Kyereboah and Coleman (2017), found that long term debt positively and significantly impacts ROE but not significantly impact on ROA of MFIs. This shows that if MFIs use long term debt to finance their operations, there may not be a pressure on management of MFI. This further suggests that profitable MFIs depend more on long term debt financing.

Pelham (2020) posited that long term debts provided small and medium-sized manufacturing firms with more competitive advantages when compared with large firms. According to Pelham (2020) found out that there is a direct positive and significant relationship between long term loans and financial performance of the small businesses. He reported that long term debt was positively related to the gross profit in small and medium size manufacturing firms.

Gatsi et al., (2020) cited Abor (2005) and Amidu (2017) that firms use a relatively lesser amount of long-term debt to finance their activities relative to short-term debt. According to Abor (2005), there exist an inverse relationship between company profitability and long-term debt. Amidu (2017) observed a positive association between long-term debt and firm profitability.

2.3. Retained earnings and financial performance of commercial banks

Retained earnings are profits not paid out as dividends but retained for financial future investment needs. The cost of retained earnings (internal equity) is the foregone benefits/dividends by ordinary shareholders. If the cost of retained earnings is low compared to the cost of new ordinary share capital, the firm will retain more and pay fewer dividends (Samuel, 2016 cited in Ilhomovich, 2019). Additionally, the use of retained earnings as an internal source of finance is preferred because it does not involve any floatation costs and does not dilute ownership and control of the firm, since no new shares are issued. According to Phillips and Sipahioglu (2019), retained earnings are an internal source of finance thus, when they are high there is low gearing, lower financial risk and thus highest market price share. It assumes that retained earnings is the best source of long term capital since it is readily available and cheap. This is because no floatation cash are involved in use of retained earnings to finance new investments.

Retained earnings are as a result of undistributed net income, prior period adjustments (error corrections) and certain changes in accounting principle, and adjustment due to quasi reorganization. Although retained earnings are the most preferred source of finance for small businesses in most of the countries (Ou & Haynes, 2016), some enterprises may exhibit a high mix of debt-to-equity because they are unable to generate retained earnings (Chepkemoi, 2019). The results of Hermelo and Vassolo (2017) held that retained earnings are used as sources to finance new projects in emerging enterprises where capital markets are not well. The study further notes that however, firms in the startup period, when initial investments have not matured yet or with investment projects substantially larger that their current earnings will not have enough financial means from retained earnings and will reach a constraint in their growth project.

Yazdanfar (2021) investigated the impact of financial structures on the growth of micro firms in Sweden and realized that retained profit significantly influenced growth of micro enterprises more than short-term debt. A study by Hsiao, Hsu and Hsu (2019) on the East Asian Tigers and Japan, observed that firms in these regions prefer to use retained earnings for two main reasons. First, firms with high profitability can obtain high retained earnings and when there is any financial deficit, the firms would use internal fund rather than fund from outside, implying that profitability would be negative to firms‟ leverage. Secondly, firms with higher profitability can obtain more net income and lead to more retained earnings to fit the additional funds needed, so debt issued would drop as profitability goes up. Gregory, Matthew, Oswald and Gardiner (2005) agreed with the claim by stating that mature firms are often able to use retained earnings as a source of financing, and thus do not require as much external financing and this is attributed to the fact that they have lower growth rates.

A survey by Moazzem (2019) in Bangladesh realized that 75% of capital required for small firms comes from retained earnings, while in those in Ecuador, Philippines and Brazil use 46%, 58% and 59% respectively as their retained earnings contribution towards their capital requirements. This means that, given the limited retained earnings of small scale enterprises; it would take about 15 years for them to be at a stage of having capital similar to that in large enterprises, provided that growth and level of inflation remained the same.

The findings of Akingunola (2021) revealed that a great number of small scale enterprises in Nigeria used internal sources of finance, mainly personal savings and retained earnings in the financing of capital equipment (Akingunola, 2021). Nasieku and Karanja (2016) opined that profitable firms are likely to use retained earnings and make less use of debt relative to less profitable firms. Similar sediments were shared in theoretical framework by Kibet et al. (2015) which indicated that when retained earnings are insufficient, they small scale firms will opt for debt rather than equity finance, because debt providers, with a prior claim on the firm‟s assets and earnings, are less exposed than equity investors to errors in valuing the firm. However, Akingunola and Oyetayo (2014) refuted the claim by stating that young firms tend to be externally financed while older tend to accumulate retained earnings (Akingunola & Oyetayo, 2014).

Ouma and Rambo (2015) discovered that small scale enterprises in Kenya relied on retained earnings and loans from informal associations, which are often unpredictable, unsecure and have a limited scope for risk sharing. This claim is supported by the findings of Akoto (2014) on the impact of micro credit on small businesses which realized that retained earnings are one of the most important sources to finance new projects in emerging economies where capital markets are not well developed. The study however noted that, firms in the startup period, when initial investments have not matured yet or whose investment projects are substantially larger than their current earnings, will not have enough financial means from retained earnings and will face a constraint in their growth project. According to the study, this may make the firms to seek external sources of financing; although the extent of borrowing could be limited by internal factors like high debt-equity ratios that would expose both borrower and lender to increased risk. This finding is in harmony with Chepkemoi (2019) who indicated that smaller businesses are heavily reliant on retained earnings to finance their investment flows and obtain most of additional finance from banks, while other resources, especially equity, are less important. In support of this claim, Brighi and Torluccio (2017) noted that on average, self-financing as a major form of finance is the preferred choice of the youngest firms.

Bayrakdaroğlu et al. (2019) demonstrated that that the highly profitable Turkish companies prefer retained earnings as their funds, thus, their debt ratio is low. This, the study claims, shows that the companies run lower risk of bankruptcy and consequently, leads to a decrease in the debt ratio of the companies in the capital structure hence leading to an increase in equity value. This behavior is in unison with the Pecking order theory which stipulates that in the presence of asymmetric information, a firm will prefer internal finance, but would issue debt if internal finance was exhausted.

Thirumalaisamy (2019) investigated on firm growth and retained earnings behavior. This was a case study of Indian Firms. The study used a random sample of 149 firms, which were considered as the most profitable for a period of 15 years from 1996-2020, the study revealed that amidst the moderate-growth firms, their fixed assets and the fixed capital requirements were financed to a great extent by equity capital and retained earnings rather than debt capital. The study also revealed that external capital, cash flow and dividend are the most influential variables showing high degree of impact on retained earnings and that on average the interest payments has not substantially reduced the retained profits. It was also evident from the study that cash flow and external sources of funds and dividend are the prominent factors influencing the retained earnings among low-growth companies. However, the study also observed that investment in fixed assets and inventory are significantly and negatively associated with retained earnings which mean that these needs are financed by external sources of funds and retrained earnings are substitutable to external funds. Lastly, it was noted from the study that cash flow and dividend are found to be the most influencing variables on retained earnings. This study connected debt finance and their relationship with retained earnings, and concentrated on profitable firms to gather their data.

Keister (2019) found out that retained earnings increased the likelihood of borrowing from all sources in the first decade of reforms. This finding is consistent with arguments that earnings signalled financial wellbeing to potential creditors and increased firm's ability to attract external funds. A study by Khan (2021) found that retention ratio and return on equity has significant positive relation with financial performance and significantly explains the variations in the stock prices of chemical and pharmaceutical sector of Pakistan. According to Khan (2021), the prime idea behind earnings retention is that the more the company retains the faster it has chances for growth.

Furthermore, Khan, Zulfiqarand Shah (2021) studied the effect of retained earnings on future profitability and stock returns and established a weak positive relationship between a firm's retained earnings and stock performance in Pakistan. According to Mirza and Azfa (2020) retained earnings ultimately come back to the equity shares in the form of enhanced dividend or capital gains.

2.4.Research gaps

According to numerous researches, capital structure decisions are determined by a complex set of factors (Chen, 2004; Mazur, 2007; Bhabra, Liu & Tirtiroglu, 2008; Frank & Goyal, 2009; Getzmann, Lang & Spremann, 2010). Bhabra, Liu and Tirtiroglu (2008) indicate that significant factors influencing capital structure decision are proportion of tangible assets, size, profitability, and growth opportunities. Furthermore, Frank and Goyal (2009) suggested that the reliable factors for explaining market leverage are median industry leverage, market-to-book assets ratio, tangibility of assets, profits, log of assets and expected inflation. The significant determinants of optimal capital structure have been disagreed over decades of empirical studies.

The financial crisis started in the US and spread beyond the US borders and shocks were felt across the world. Whereas the cause of the crisis was attributed to the US housing market (Marshall, 2009), the response by banks and their resilience depended on the adequacy and quality (debt-equity mix) of their capital. When examining the roots of the crisis, Greenlaw, Hatzius, Kashyap and Shin (2008) find that banks‟ active management of their capital structures in relation to internal value at risk, rather than regulatory constraints, is a critical factor. Financial crises are bound to recur and since effective response to financial crisis is depended on banks‟ capital adequacy and quality (debt-equity mix) it is imperative that banks manage their capital structures effectively.

Pastory, Marobhe and Kaaya et al (2013) portrayed negative nexus in between funding structure and bank efficiency in Tanzania. Nonetheless, Makoni, (2014) on money and also company features in Tanzania showed only take advantage of operationalized financial debt to equity as well as financial obligation to total funds favorably and substantially effects return on equity. In Uganda, Yosia, (2017) while researching the result of debt monitoring on commercial bank economic efficiency in Uganda revealed that stakeholders play a huge duty in enhancing the credit rating plan for instance making sure that long term debts can be recouped beyond one financial year as well as short term financial debts are recuperated in one financial year.

Furthermore, Serwadda (2019) in a research study on the impacts of resources structure on financial institutions' performance, the Ugandan perspective, came to the conclusion that complete financial obligation positively as well as dramatically effects return on possessions. Nonetheless, a research study by Harelimana

(2017) on exactly how debt funding influences banks' efficiency, Rwanda concluded that financial obligation level favorably as well as substantially influence the productivity for both I&M financial institution and other financial institution of Kigali. The visibility on non-consensus on how capital framework effects bank efficiency motivating this research in the context of Ugandan commercial financial institutions.

CHAPTER THREE

III. RESEARCH METHODOLOGY

3.0. Introduction

This chapter presents the methodology that the study followed. It explains the design; study area; population; sample size, sampling techniques and procedure; data collection instruments; methods of testing the validity and reliability of instruments; the research procedure that was followed; and the data management and analysis techniques that was used in conducting the study.

3.1 Research Philosophy.

The study will consider two types of research philosophies; subjectivist and constructivism (phenomenology) and objectivist (positivism). According to Gass and Mackey (2013) positivism philosophy subscribes to the view that only factual knowledge gained through observation (the senses), including measurement, is trustworthy. In positivism studies the role of the researcher is limited to data collection and interpretation through objective approach and the research findings are usually observable and quantifiable. The emphasis is to test theories that have already been posited. The study depends on quantifiable observations that lead themselves to statistical analysis. As a philosophy, positivism is in accordance with the empiricist view that knowledge stems from human experience. It has an atomistic, ontological view of the world as comprising discrete, observable elements and events that interact in an observable, determined and regular manner (Collins, 2011). This study will adopt the positivism philosophy. Data will be collected, statistically analysed and research findings derived from observable and quantifiable measures with a view to testing capital structure theories. As a philosophy, positivism is in accordance with the empiricist view that knowledge stems from human experience (Gass & Mackey, 2013) and this is the view that anchors this study. Duff (2012) argue that as a general rule, positivist studies usually adopt deductive approach and relates to the viewpoint that a researcher needs to concentrate on facts. Studies with positivist paradigm are based purely on facts and consider the world to be external and objective.

3.2. Research design

The study will employ a descriptive- cross sectional research design. A descriptive study is used to describe or define, often by creating a profile of a group of problems, people or events, through the collection of data and tabulation of the frequencies on research variables or their interaction (Cooper and Schindler, 2003). Descriptive research design enables the researcher to generalize the findings to a large population. The descriptive research approach was appropriate due to the fact it allows analysis and relation of variables.

3.2 Study population

The study targets all banks that are operating in Ibanda district. The study population will involve management, staff and clients of Stanbic bank DFCU bank and centenary bank. A population of 190 respondents will be used for the study.

3.3 Sample size

The study will use a sample size of 127 respondents who will be obtained from the management and Other employees of commercial banks operating in Ibanda district. The sample size will be determined using tables of Krejcie & Morgan (1970). According to Senkaran (2003) the appropriate sample size for a population of 500 should be 30. In this case, a sample of 127 of the population of 190 is appropriate for this study. However Amin (2008) recommends a sample size of up to 20% of the population for descriptive research depending on the nature of the descriptive research, the size of the population and whether it can be analyzed for the given sub- groups.

Category of respondents	Population	Sample size	Sampling technique
Managers of commercial banks	3	3	Purposive
Other Employees of commercial banks	186	124	Simple random
Total	**190**	**127**	

Source: Researcher, 2024

3.4 Sampling technique

The study will use purposive sampling. Under purposive sampling technique, the researcher purposely chose who, in his opinion are thought to be relevant to the research topic. In this case, the judgment of the researcher was more important than obtaining a probability sample. The process of sampling in this case involved will be purposive identification of the bank managers. The respondents to be involved in the study are assumed to all the information relating to the study since the problem under study lies in their department. The researcher also employed simple random sampling when selecting employees of the commercial banks.

3.5.0 Data collection methods.

3.5.1 Interview

This will involve verbal interchange, often face to face, though the telephone were used in which an interviewer tries to elicit the information, benefits, opinions from another person. In relation to the above, this method will be administered management staff of commercial banks operating in Ibanda district. The researcher used this method to obtain firsthand information from them in details since the researcher will have a chance to probe through asking pre-determined questions.

3.6.2 Questionnaire survey

The researcher will adopt the Survey approach in collecting data. The instrument will be delivered to banks physically and the contact responsible person will be requested to fill the questionnaire. After filling the questionnaire; the researcher will collect back the filled questionnaires, even though others will be deferred for another day. Follow up will be made and up to 80% of the questionnaires will be collected.

3.6.3 Documentary review

In the secondary analysis of qualitative data, good documentation cannot be underestimated as it provides necessary background and much needed context both of which make re-use a more worthwhile and systematic endeavor (Kothari, 2004). Secondary data is obtained through the use of published and unpublished documents (Junker and Pennink, 2010). Various publications, magazines, newspapers, credit risk reports, Credit risk hand books, historical documents and the Financial Institutions Act and other sources of published information will be reviewed by the researcher. According to Ragin (2011), secondary data is helpful in the research design of subsequent primary research and can provide a baseline with which the collected primary data results can be compared to other methods. According to Somekh and Lewin (2005), documents are helpful in the research design of subsequent primary research and can provide a baseline with which the collected primary data results can be compared to other methods.

3.7. Data collection instruments

3.7.1 Interview guide

The researcher will use an interview guide to collect information from staff managers of commercial banks in the study area. The interview guide collection instrument will be semi structured in nature for the convenience of the interviewer. It also involves meeting respondents face-to-face and collecting information from selected respondents. The method also involves probing in addition to asking predetermined questions so as to create a rapport between the interviewer and the respondents. This will be used to ensure accurate information and it allows deeper investigation into the study problem. Interviews will enable the researcher to observe non-verbal behaviors with ease.

3.7.2 Questionnaire:

Is a set of formalized questions used in a survey to collect information and is later analyzed to provide results necessary for solving a given research problem. Like any good test, questionnaires ask for information that respondents have. The researcher will use the questionnaire as a data collection instrument because it is cheap, time saving, easy to administer, effective and it is the best form of obtaining information from the respondents. In this instrument, the researcher will use both closed and open ended questions.

3.7.3 Documentary review check list

This will involve a list of documents to be reviewed to get the relevant data about the topic under study.

3.9. Data quality control

3.9.1 Validity

Validity, according to Borg and Gall (1989) is the degree to which a test measures what it purports to measure. All assessments of validity are subjective opinions based on the judgment of the researcher (Wiersma, 2020). The pilot study will help to improve face validity of the instruments. As such, the researcher will seek assistance of his supervisor, who as an expert in research helped improve content validity of the data. Data will be collected confirming to the tests of validity. The validity of the data will be guaranteed because the research tools used in the study was designed to capture all the relevant information required to fulfill the objectives of the study. Where questionnaires will not be applied, interviews will be used to get into deep analysis of the matter. An acceptable content validity index (CVI) of 0.7 will be employed and calculated using Amin's (2005) formula as:

$$\text{CVI} = \frac{\text{No. of Questions (Items) declared Valid}}{\text{Total No. of Questions (Items)}}$$

3.9.2 Reliability

The pilot study will enable the researcher to assess the clarity of the questionnaire items so that those items found to be inadequate or vague was modified to improve the quality of the research instrument thus increasing its reliability. The researcher will pre-test the instrument to a pilot sample of 10 respondents, to help in detecting any research methodology problems. The scores of the responses will be correlated using Cronbach's alpha coefficient. According to Kothari (2014), an alpha of 0.7 or higher is sufficient to show reliability; implying that the closer the alpha to 1, the higher the internal consistency reliability. The reliability of data will be confirmed by the approval of data collection methods and tools by the university through the research supervisor, pre-testing the tools and careful choice of relevant questions and words will be used in the study. According to Cronbach (1950), coefficient alpha of 0.7 and above is considered adequate.

3.10. Data analysis

Quantitative data analysis

The statistical package which will be used for analysis of data in this study is the SPSS version 23.0. Different statistical techniques will be used namely: correlation and regression analysis. The upper level of statistical significance for hypothesis testing will be at 5%. All statistical test results will be computed at 2-tailed level of significance. Descriptive statistics namely frequency counts, percentages will be used to analyze the respondents' demographic characteristics and the mean and standard deviation will be used to analyze the respondents' opinions the relationship between capital structure and financial performance of commercial banks in Ibanda district. Data will be analyzed and correlated using Pearson Product-Moment correlation coefficient to establish the relationship the relationship between the variables under investigation.

Analysis of qualitative data

Qualitative data will be analyzed using content analysis. Responses from key informants will be grouped into recurrent issues. The recurrent issues which will emerge in relation to each guiding questions will be presented in the results, with selected direct quotations from participants offered as illustrations.

3.11. Ethical Considerations

Honesty: There are several reasons why it is important to adhere to ethical norms in research. First, norms promote the aims of research, such as knowledge, truth, and avoidance of error. For example, prohibitions against fabricating, falsifying, or misrepresenting research data promote the truth and avoid error. Second, since research often involves a great deal of cooperation and coordination among many different people in different disciplines and institutions, ethical standards promote the values that are essential to collaborative work, such as trust, accountability, mutual respect, and fairness (Amin, 2005). To avoid plagiarism, the work will be subjected to the anti-plagiarism test using the anti-plagiarism software called turn it in of different authors will be acknowledged whenever they are cited.

Informed Consent: The ethics framework is essential as it entails the voluntary informed consent of the participants. This requires giving the participants adequate information about what the study involved and an assurance that their consent to participate would be free and voluntary rather than coerced. According to Sekaran (2003) participants informed consent may be obtained either through a letter or form that clearly specifies what the research involves, includes clearly laid down procedures the participants can expect to follow and explain the ways in which their confidentiality will be assured. In this case, a letter will be obtained for this purpose. It will be imperative to describe possible risks and benefits of the research (Sekaran, 2003). The signing of the voluntary informed consent by each individual participant will be confirmation that the respondents are not coerced to participate in the study but are doing so willingly. The researcher will explain to the participants that an audio tape will be used to record interviews. The researcher will make the respondents aware of their right to opt out of the study if they so wish and that recording would only be done with their approval. In all the interviews, the participants will first consent to the use of audio tape. Some respondents required further verbal assurance that the tapes will be under no circumstances to be handed over to their supervisors.

Anonymity: Respondent's names will be withheld to ensure anonymity and confidentiality in terms of any future prospects. In order to avoid bias, the researcher will interview the respondents one after the other and ensure that she informs them about the nature and extent of her study and on the other hand she gave them reasons as to why will be interviewing them.

Confidentiality: The researcher will protect confidential communications by informing respondents that participating in this study does not mean that they are giving up on any of their legal rights. The respondents will be informed that recording both audio and video is an integral part of the study, the records of the interviews taken will be kept confidential and any other data collected. The data will be used for only academic purposes and not after be used against them or their offices. The records of this study will be kept confidential. The records will be destroyed after transcription and data kept on a personal computer.

Objectivity: The researcher will avoid bias in experimental design, data analysis, data interpretation, peer review, personnel decisions, grant writing, expert testimony, and other aspects of research where objectivity will be expected or required. He will avoid or minimize bias or self-deception.

3.12. Anticipated limitations of the study

The researcher will use SPSS programme in data analysis, thus the results on the reliability tests, correlations and regressions will all be based on the data set in the system. Hence, an error in the data input may have adverse effects the accuracy of the output. The researcher will however be keen enough in data entry and analysis to ensure that actual data collected is the one coded and analyzed.

Bureaucracy of the administration in the financial institutions may make it hard for the researcher to reach the sample target in time. This will be mitigated by being patient with the authorities of financial institutions up to when the researcher will be allowed to interact with the employees and agents of the financial institutions.

Some respondents may not be ready to answer the questions, or spare time for the study. This may delay the study and reduce the study sample. However, the researcher will explain the purpose of the study to respondents and develop simple and straight forward tools. This will encourage most of the participants to take part in the study confidently.

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