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A STUDY ON "COST OF CAPITAL FOR FINANCIAL INSTITUTION"

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Abstract

One of the fundamental ideas in corporate financial management, cost of capital is both the cost of corporate financing and a factor in how businesses finance themselves as well as the necessary rate of return for investors, which influences investment activities. How is the cost of capital determined? What are the variables that affect the cost of capital? These two inquiries will be crucial in determining if India's capital costs are high and in advancing the supply-side reform's goal of cost reduction.

Keywords

Cost of Capital, Literatures Review, Research Methodology, Data Analysis.

1. INTRODUCTION

A financial institution's cost of capital is the price it pays to raise money from various sources to fund its operations and investments. It stands for the bare minimum return on investment that the financial organisation must achieve in order to appease its backers and lenders.

Financial institutions have access to a variety of funding options, including equities, debt, deposits, and other funding sources, to raise cash. Depending on elements like market conditions, creditworthiness, and the financing terms, each of these sources has a unique cost.

2. LITERATURE REVIEW

A. Easley, David, and Maureen O'hara. "Information and the Cost Of Capital For Financial Institution." ***The journal of finance*** **59.4 (2104): 1553-1583.**

In this research author said, the cost of capital is reducing the risk of losses when we invest in different methods, basically The Cost Of Capital is the weighted sum of the cost of equity and the after tax cost of debt they are mostly use. A starting point for calculating the cost of equity is the S&P 500 (or similar broad index).

B. Modigliani, Franco, and Merton H. Miller. "The Cost Of Capital For Financial Institution, corporation finance and the theory of investment." ***The American economic review*** **48, no. 3 (1958): 261-297.**

In this research author said, the formal analysis, the economic theorist at lest has tended to side-step the essence of this Cost Of Capital problem by proceeding as through physical assets like – bonds etc.

C. King MA. Taxation and the Cost Of Capital For Financial Institution. The Review of Economic Studies. 1974 Jan 1;41(1):22-35.

In this research author said, for the comparison between Cost Of Capital and Tax, because how much to be paid extra expenses like taxation in what percentage like that… the way in which taxation affect the corporation financial policy, and the level of investment through the structure the Cost Of Capital For Financial Institution.

D. Solomon, E. (1963). Leverage and the Cost Of Capital For Financial Institution. ***The Journal of finance, 18*****(2), 273-279.**

In this research author said, THE PROPER USE of debt financing is one of the major decision areas of corporate financial management. My paper confines itself to just one facet of the many considerations which jointly determine the optimal use of debt—namely, the effect that a change in financial leverage has, or can be assumed to have, on a company's Cost Of Capital. In particular, it addresses itself to the thesis put forward by Modigliani and Miller that, apart from a tax effect, a company's Cost Of Capital is independent of the degree of leverage in its financial structure.

E. Bradley, Michael, Gregg A. Jarrell, and E. Han Kim. "On the existence of an optimal capital structure: Theory and evidence." The journal of Finance 39, no. 3 (1984): 857-878.

In this author said that, On the other hand, in the presence of financial distress cost (bankruptcy costs and agency cost of debt), there is a positive relation between capital structure and firm performance at lower level of debt, and a negative relation at higher level of debt. This paper summarizes the development of the theory of capital structure since 1952, This suggests that possible maximum debt is optimum.

F. Clark, G. (1988). The Cost Of Capital For Financial Institution and medieval agricultural technique. *Explorations in economic history*, *25*(3), 265-294.

In this research author said, The extent and timing of this fall is examined using rent charges and the returns on holding land from 1151 till 1850. High interest rates explain several features of the medieval economy, including most elements of the much debated open-field system.

3. RESEARCH METHODOLOGY

3.1 PROBLEM STATEMENT OF THE STUDY : The problem in this research is that, ―As millennials are spending their most of the time on wrong funding arising and issuing for Equity and borrowing Debts without calculate the cost of capital and without any help of best management team. Some of the companies to borrowing high rate of interest paid and their cost of capital is very high.

3.2 Objectives of the study: -

In order to generate a suitable return for its shareholders and to ensure the long-term viability and profitability of the business, a financial institution must analyse its cost of capital in order to estimate the minimum required rate of return on its investments.

3.3 Hypothesis: -

- According to the hypothesis, the cost of capital for financial institutions is higher than for other industries because of the particular risks and difficulties they face. This cost of capital can also change depending on the institution's unique characteristics, business model, and operating environment.
- The financial institution's investment choices, capital structure, and general financial performance are also anticipated to be significantly impacted by the cost of capital.

3.4 Research Design :-

Descriptive Research design is chosen for the research. Descriptive research is defined as research methods that describe the characteristics of the procurement or financing being researched.

3.5 Source of Data

We have to use secondary data, the secondary data has been generated with the help of internet and its multiple websites, journals, research papers.

3.6 Sampling method

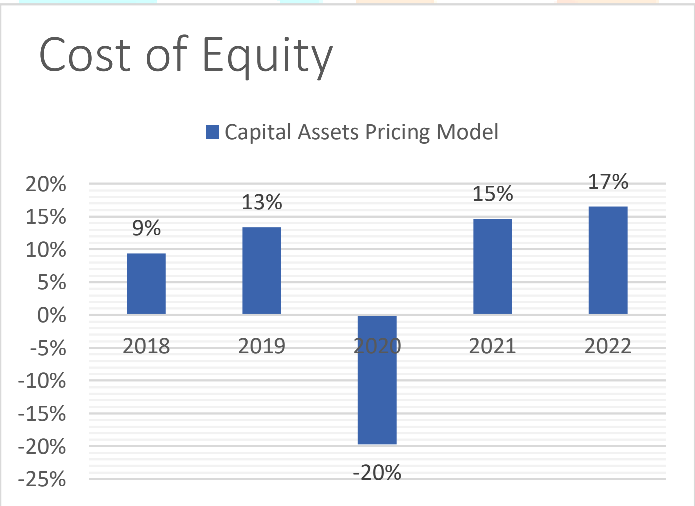
Convenient sampling method used as sampling design under probability method

3.7 Sampling frame

The research has been conducting in the Gujarat. The wide area where the research will take on Annual Report, Balance Sheets, Study material for various Institutes.

4 DATA ANALYSIS

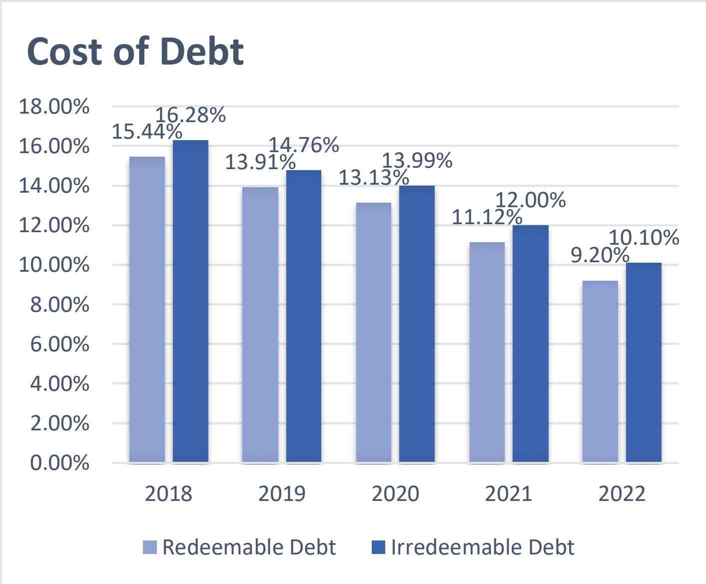
A. Calculate Cost of Equity for Muthoot Finance Ltd.



Interpretation:

- Cost of the equity in 2022 is very high i.e 17% in last 5 years.
- In 2020 cost of the equity is negative because the market rate of Nifty is fall down i.e -26% due to the pandemic. For that the cost of equity is negative.

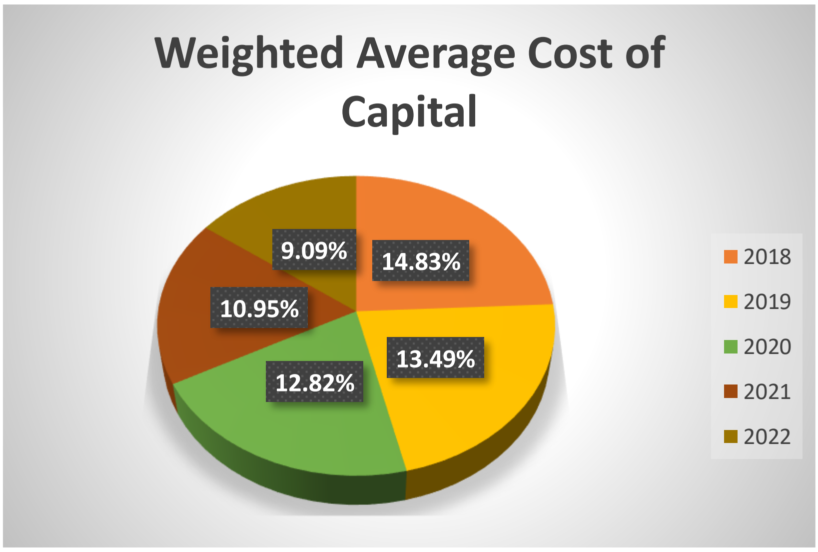
B. Calculate Cost of Debt for Muthoot Finance Ltd.



Interpretation

- In above chart to analysis that in 2018 cost of debt is very high in both the method irredeemable and redeemable debt, rate is 15.44% & 16.28% high.
- In last 5 year cost of debt is consistently reduce.

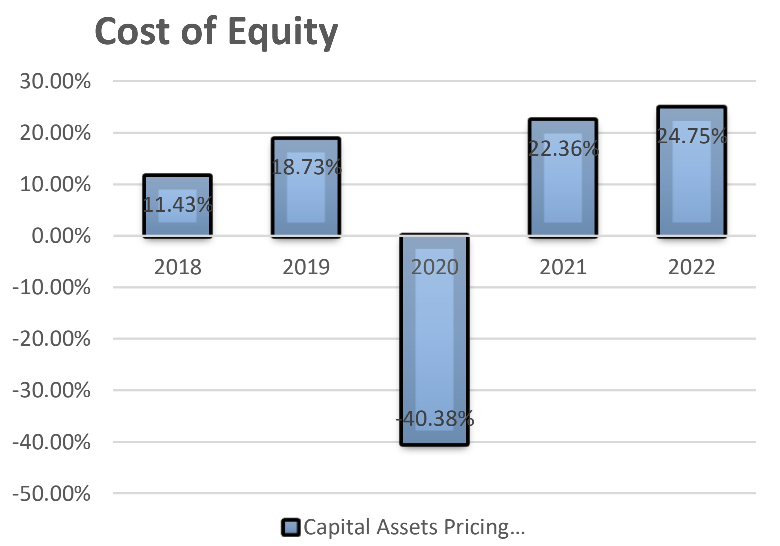
C. Calculate Cost of Capital using WACC for Muthoot Finance Ltd.



Interpretation

- In above chart analysis that the cost of capital in 2022 is lower than 2018.
- In given chart lower the cost of capital is low because cost of equity and debt is low in last 5 consecutive year.

D. Calculate Cost of Equity for Power Finance Corporation Ltd.

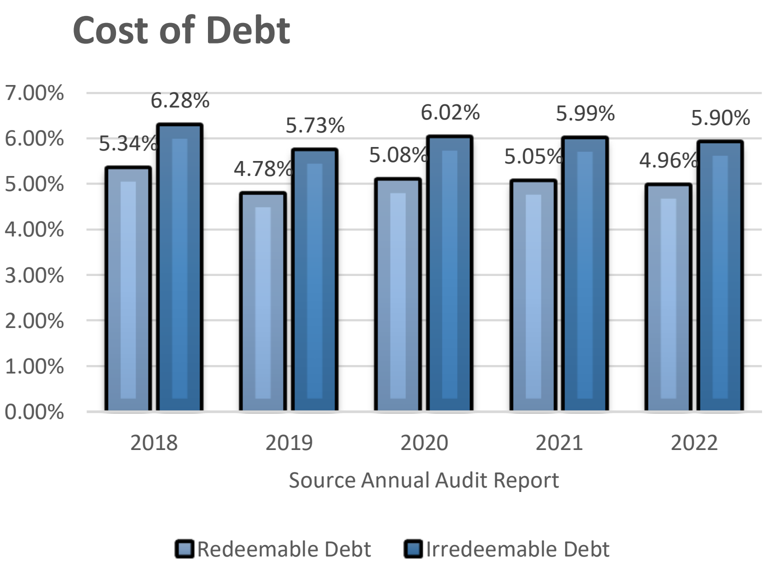


Source Annual Audit Report

Interpretation

- In given chart Cost of equity is more in 2022 i.e 24.75% because market rate is more i.e 19% as compared to previous year i.e 17%.
- In 2020 cost of equity show in negative it means company does not pay any of dividend.

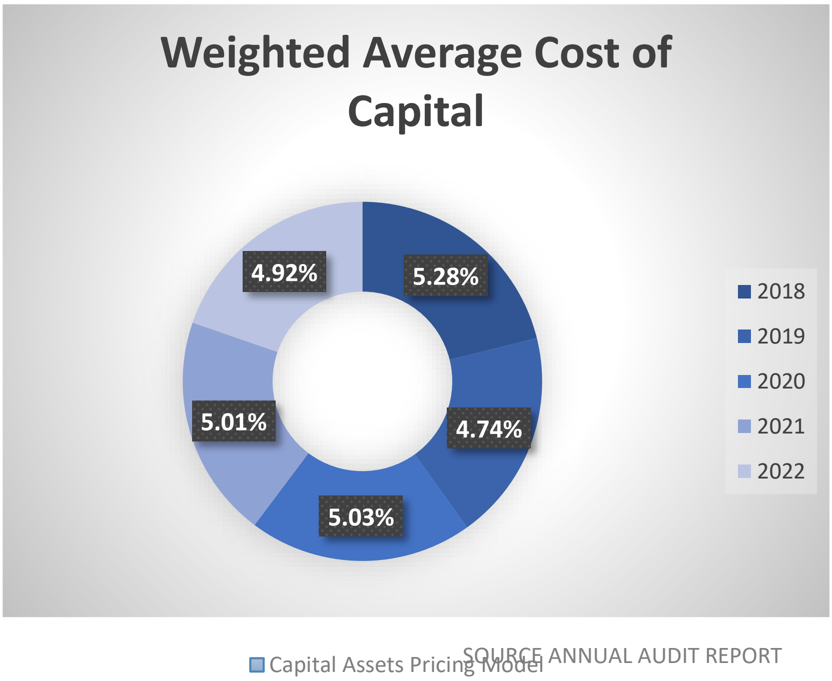
E. Calculate Cost of Debt for Power Finance Corporation Ltd.



Interpretation

From the analysis of the data most suitable fund raising is redeemable debt their cost of debt id approx. 5% in all five consecutive year.

F. Calculate Cost of Capital using WACC for Power Finance Corporation Ltd



Interpretation

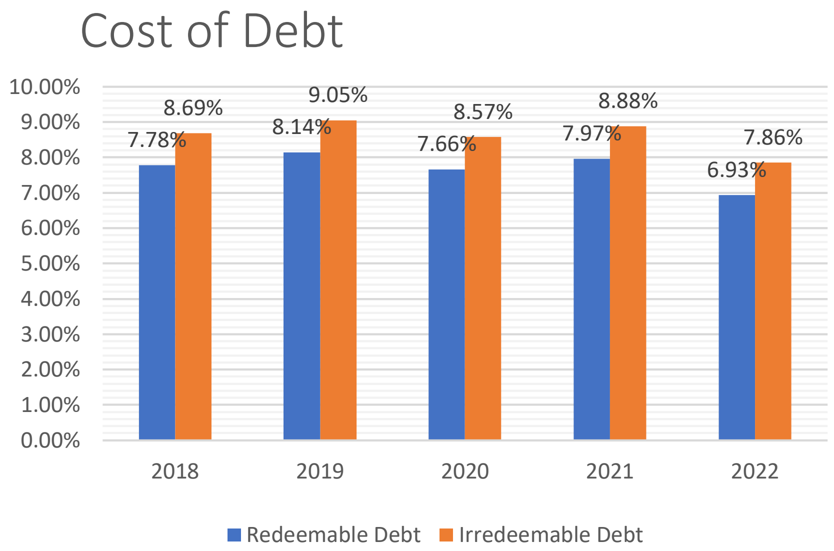
From the given chart less cost of capital given in 2019 that is 4.74% its include cost of equity and cost of debt. Where as the cost of equity is very less.

G. Calculate Cost of Equity for L&T Finance Ltd.

Interpretation

- In this data cost of capital Is very high in 2022 that is 29.38% as compare to other four company.

H. Calculate Cost of Debt for L&T Finance Ltd.

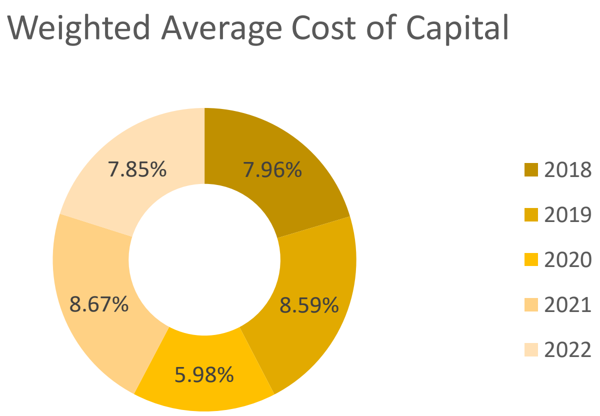


SOURCE ANNUAL AUDIT REPORT

Interpretation

In the given chart to the analysis that the redeemable debt is between 7% to 8% and irredeemable debt is between 7.5% to 9%

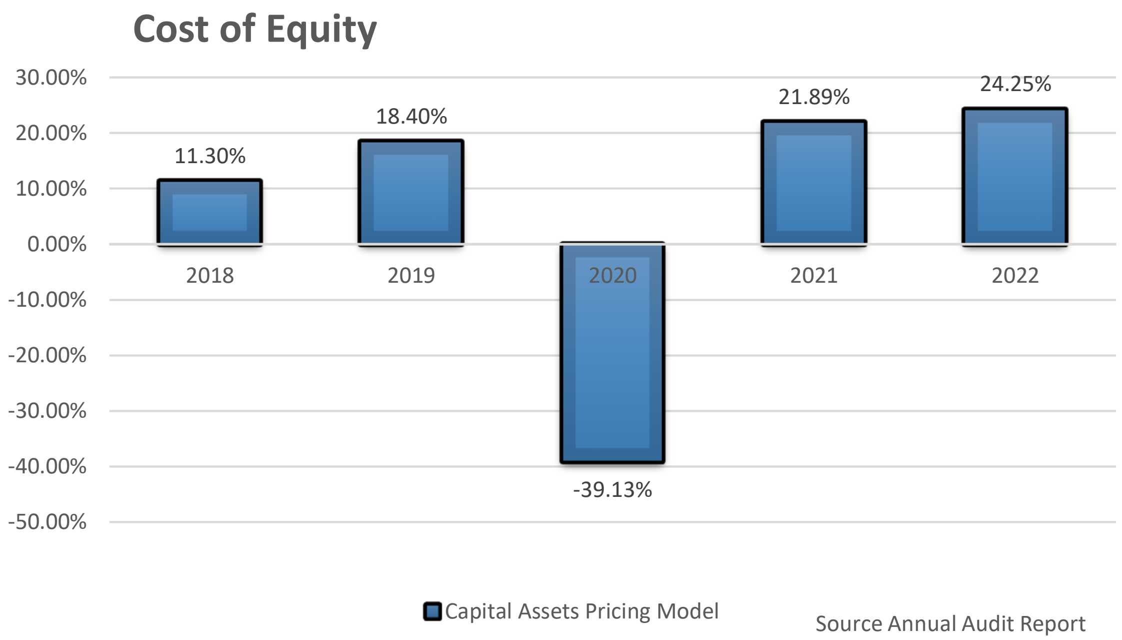
Calculate Cost of Capital using WACC for L&T Finance Ltd.



Interpretation

- For the given data to analysis that the lower rate is 5.98% there after borrowing amount is increase in 20220 but the market rate is negative

I. Calculate Cost of Equity for Shriram Finance Ltd.

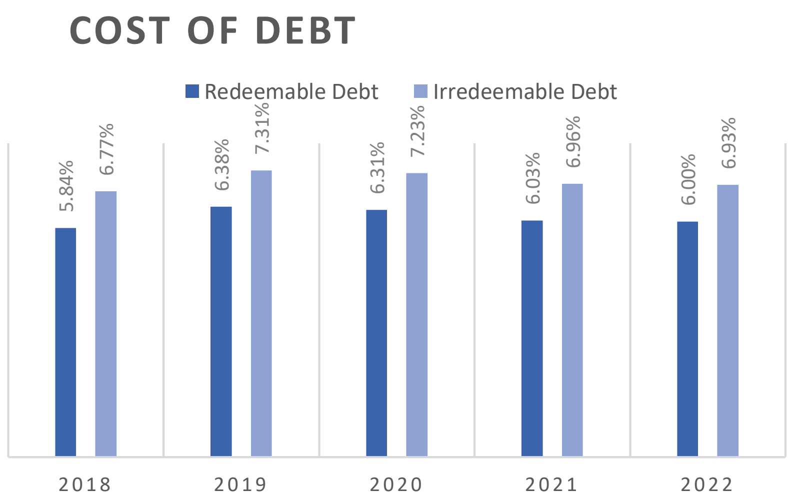


Source Annual Audit Report

Interpretation

For the given data and the chart analysis high cost of equity in 2022 that is 24.25% because the Beta **(β)** factor is more than 1.

J. Calculate Cost of Debt for Shriram Finance Ltd.

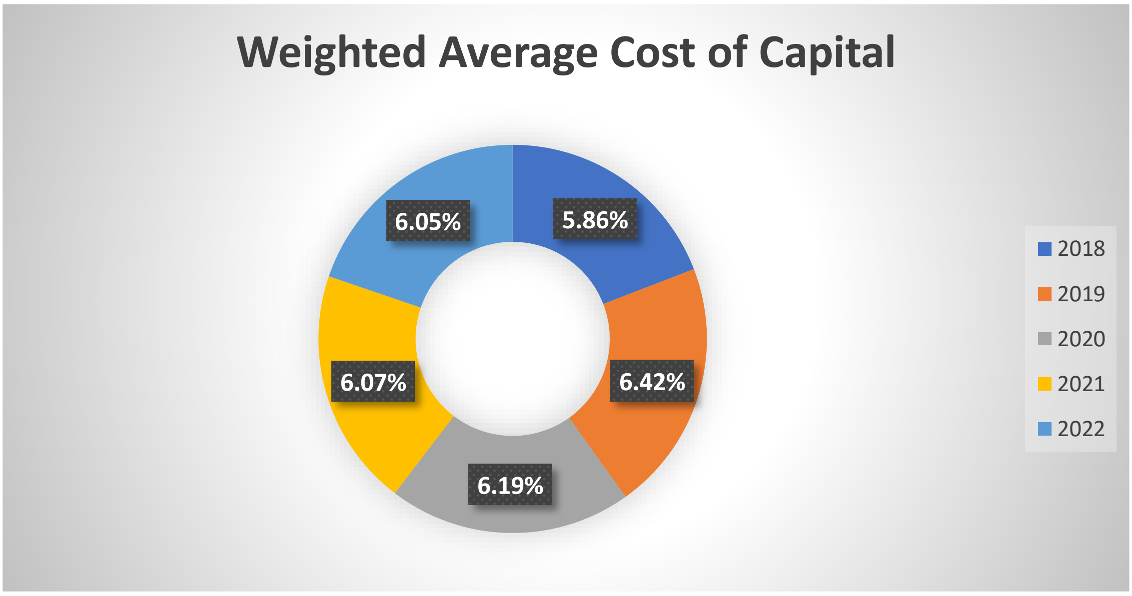


SOURCE ANNUAL AUDIT REPORT

Interpretation

- For the given data analysis cost of capital in 2 year is almost same 6.3%.
- That company have increase our debt in term of borrowing in last 5 years.

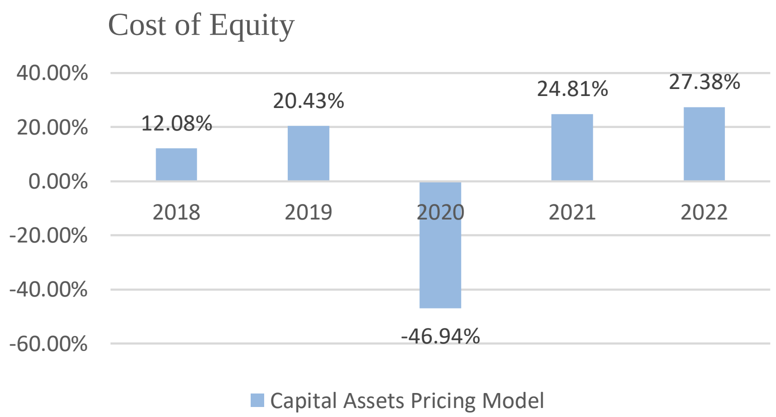
K. Calculate Cost of Capital using WACC for Shriram Finance Ltd.



Interpretation

- For the WACC method cost will be between 5.8% to 6.5%
- Cost of debt is same in last 5 years but cost of equity will be change.

L. Calculate Cost of Equity for Aditya Birla Capital Ltd.

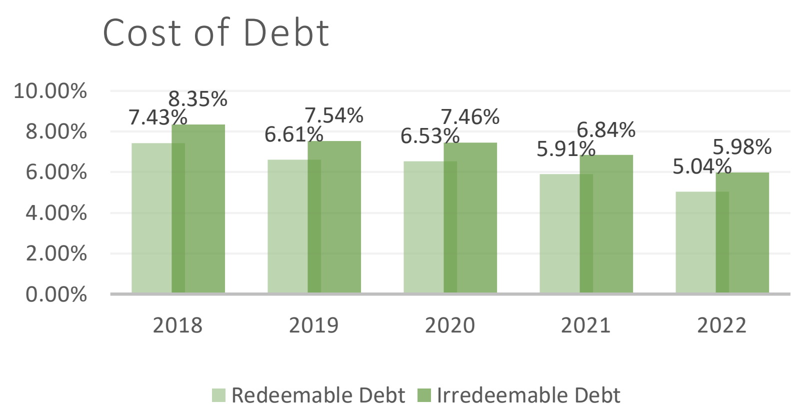


Source Annual Report

Interpretation

- For the analysis data cost is high in year 2022 that is 27.38% for the reason is Beta is more than 1 that is 1.67 and market rate also high return that is 19%

M. Calculate Cost of Debt for Aditya Birla Capital Ltd.

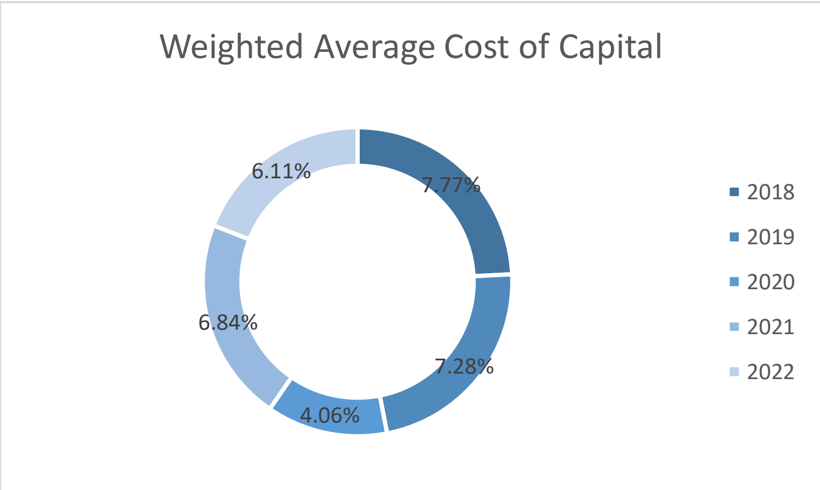


SOURCE ANNUAL REPORT

Interpretation

For the given chart analysis that the cost of debt is reduce form 7% to 5% in redeemable and 8.5% to 6% in irredeemable debt.

N. Calculate Cost of Capital using WACC for Shriram Finance Ltd.

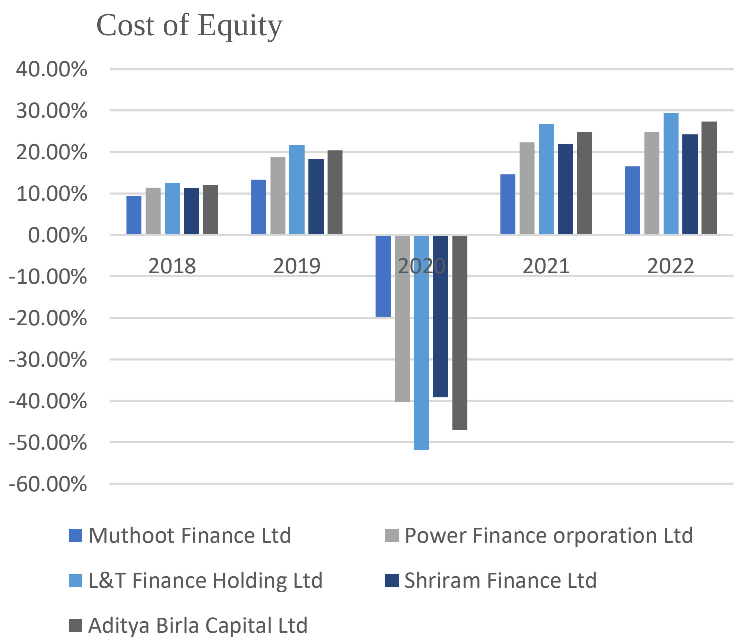


Interpretation

For the analysis that the cost of capital is reduce 7.77% to 6.11% . And in 2020 cost will be 4.06% because the market rate is negative but the debt interest will be pay.

❖ Compare all Five Companies

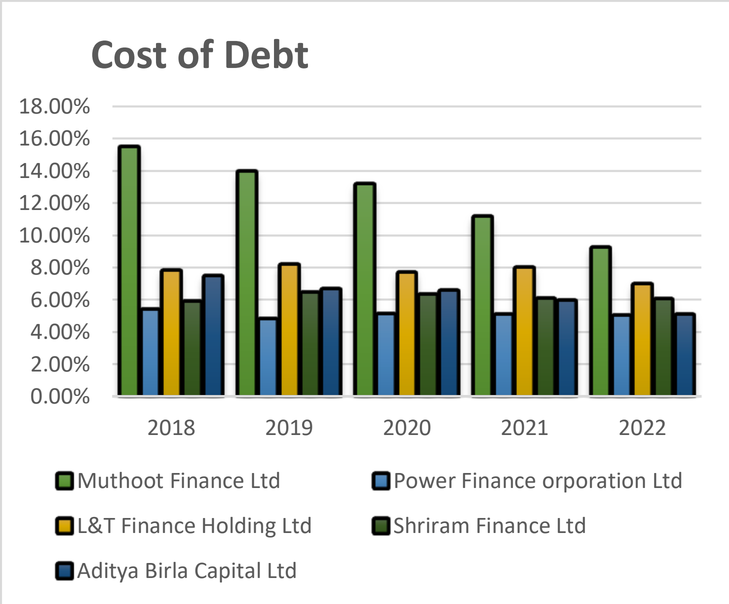
1. Cost of Equity



Interpretation

- For the above data analysis high cost of equity in every year is L&T finance ltd. As compare to another companies.
- The low cost of equity is given to Muthoot Finance Ltd. In all the 5 year, as compare to another 4 companies.

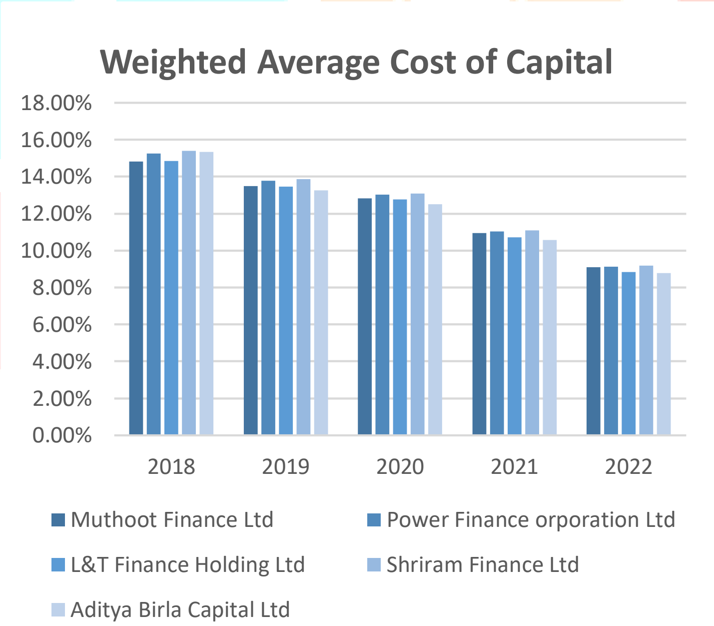
2. Cost of Debt



Interpretation

- For the data analysis high cost of debt is Muthoot Finance Ltd. Is more than 8% high as compare to L&T company.
- In the cost of debt least cost will be Power finance Ltd. Company as compare to another, in all time cost is below 6%

3. Weighted Average Cost of Capital



Interpretation

- L&T Company has the best cost of capital rate for the company, which ranges from 8% to 15% when using WACC.
- As compared to the costs of equity and debt, the WACC presented is relatively high return, but it will consistently decline.

FINDING

According to the analysis of the data provided, Muthoot Finance Ltd. is the best company in terms of equity cost. because they have a lower beta () value than the other companies. Additionally, we evaluate market risk using the Capital Assets Pricing Model (CAPM) technique.

Due to their low borrowing amount and low interest rate of 7.2%, Aditya Birla Capital has the best cost of debt return when compared to other companies, who have taken on borrowing rates higher than 7.5%.

We Power Finance Corporation Ltd. will find the WACC approach to have the optimum rate of return. Their research is of the highest calibre, and their management team is well qualified.

In whole of the research comprising the companies Muthoot Finance because their cost of equity is low.

❖ CONCLUSION

For financial institutions, the cost of capital is a critical aspect because it has an impact on their profitability and capacity for raising capital. Making wise choices about capital budgeting, risk management, and capital structure requires accurate cost of capital estimation. The capital cost of capital for financial institutions is often calculated using the capital asset pricing model (CAPM) and the weighted average cost of capital (WACC). Many elements, including current interest rates, credit risk, and market volatility, have an impact on the cost of capital. To guarantee they are making educated judgements, financial institutions must keep an eye on these variables and modify their cost of capital estimations as necessary.

Next, we can calculate the cost of capital in various ways to ensure the accuracy of the calculation. Alternatively, we should actively explore other influencing factors and pay more attention to their combined effect than to the influence of any one of them. This is helpful for assessing and lowering the cost of capital and positively responding to the demands made by supply-side structural reform.

❖ REFERENCE

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➢ **Websites**

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