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The impact of country specific factors on capital structure of banks in Azerbaijan

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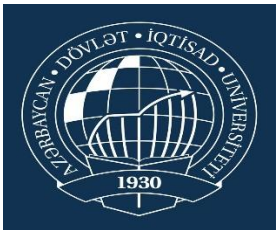

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Abstract

This research paper investigates the impact of country specific factors such as minimum capital requirement, deposit insurance, and taxation principle on capital structure of banks. Investigation shows that properly regulated banks consider these factors when they determine to maintain capital more than the minimum required. The main reasons are associated with tax advantaged debt and dividend tax. Deductable interest expense and dividend tax induce banks to hold more debt rather than equity. This study clearly shows that Azerbaijan banks prefer debt because of its advantages. In order to get this consequence the financial statements of commercial banks are analyzed. This financial reporting information which is based on a sample of five banks can provide a comprehensive proof to support our argument, because these five banks are the largest banks in Azerbaijan, furthermore they are dominant and their status can represent all banks. The consequences of study indicate that country specific factors have a significant influence on capital structure of banks in Azerbaijan.

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1. Introduction

1.1 Problem background and significance of the study

The issue of capital structure has been essential for Azerbaijan banks over the three years, a period noted by the disastrous financial crisis since the devaluation. Banks capital has been under serious stress as a consequence of enormous increases in bad debts and losses on profit. Therefore, the decision of capital structure policy plays a vital role in their activity and it is also very important in current Azerbaijan economy. Previous banks have shown that, problems in one bank could have negative affected to all society and its consequences caused to diminish the economic development.

The recent financial crisis demonstrates that immensely leveraged capital structures are a critical source of risk for banks as financial institutions. Furthermore, holding lower amount of equity and high amount of debt is not optimal choice and it cannot be beneficial for banks. Banks like financial intermediaries are different than other companies. So, banks have the exclusive advantage of being able to issue an insured debt, but they also carry the capital regulations. In addition banks also control financial instead of physical assets implying minor bankruptcy cost rather than industrial companies. This paper inspects how these significant characteristics have an impact on the capital structure of banks. In order to analyze the influences of country specific factors on capital structure of Azerbaijani banks, their debt and equity indicators are analyzed. This information has come from banks' financial statements for at 31 March 2018. The financial leverage and debt-equity ratios have provided adequate implications to prove the main argument.

1.2 Purpose of the research paper

In Azerbaijan, a significant amount of legislation has been engaged to control financial activities on a bank level for the objective of supporting bank's sustainability and protecting stakeholder rights. These statutory supervisions contain minimum share capital requirement, dividend restriction, deposit insurance, and thin capital rules. Thin capital rules have a connection to statutory regulations that restrict the deduction of interest expense from taxable income in the scenarios where banks' debt are regarded as very high compared to their equity. This capital rules normally describe a highest debt to equity ratio, which means authority does not allow banks to reduce taxable income by the interest expense relating to the enormous portion of debt. The main role of this capital rules is to deal with possible tax avoidance issues.

This research paper seeks to provide an initial empirical analysis of the influences of statutory equity and minimum share capital requirements, deposit insurance and dividend restrictions on capital structure of banks. The paper consist of theoretical and empirical analysis in order to determine the legal factors which influence bank's financing and investing decisions. The consequences of this study can launch a new suggestion for beneficial changes in Azerbaijan's economic policy and legislation.

Previous researches of bank capital structure have created conflicting predictions. Capital structure theories pursue to explain why companies choose various mixes of equity and debt to provide finance their operations. Banks represent a special argument because of individual features in the industry. The financial crisis of the past three years added another set of special conditions in which banks needed to increase capital. The previous banks have shown for holding too much debt instead of equity could result in negative consequences. Therefore, in order to ease these problems the new proposal can be considered as a beneficial research which considers the optimal balance between debt and equity.

An influential paper by Modigliani and Miller (1958) demonstrates that in perfect capital markets, the source of financing does not matter because the value of the company is unrelated to how equity and debt claims are arranged. The research contributes powerful perceptions into the division of investment and financing decisions. In perfect capital markets, what occurs on the left side of statement of financial position which determines firm value is unrelated to the financing on the right side of the statement of financial position. In practice, nevertheless, capital markets are not perfect and therefore financing obviously does matter. With these incompleteness and financial frictions, the value of a company can go up or down depending on its financing mix. In general, a company will seek to adapt its capital structure to optimize its value. In order to investigate how financial frictions influence the decision of capital structure, this study begins with a summary of previous literature have done in the field of capital structure and it mainly examines three theories: the tradeoff theory, the pecking order theory, and the free cash flow theory. In this part common capital structure theories and banking capital structure theories are discussed and the consequences of this discussion provides an adequate evidence to the argument which considers the impact of country specific factors on capital structure of banks.

2. Literature Review

2.1 Capital structure theories and an empirical literature

Recently, many theories have been proposed to demonstrate the variation in financial leverage ratios across companies. The theories indicate that companies choose capital structure depending on aspects which determine various costs and benefits connected with equity and debt financing. A number of empirical researches in this field have been worked behind the theoretical assumptions and they have dealt with the argument whether an alteration in capital structure affects the value of a company. These empirical researches have proposed that, in generally capital structure decisions depend on internal or firm specific and external or country specific factors.

Analyzing different factors as determinants of capital structure has been one of the most trending research topics in finance and accounting. There was no common accepted theory of capital structure until Modigliani and Miller improved the capital structure inappropriateness argument in 1958. Modigliani and Miller assumed that it is not essential what capital structure a company use in order to provide with money its operations in developed markets, furthermore, the centre determinants of the firms' fair value are its earning ability and the risk of fundamental assets. Financial leverage which is the portion of debt financing is unrelated to the total firm value. This unrelated leverage result generalizes to any combine of issued financial securities by the firm, the total value is not influenced by the portion of long term or short term debt, callable or puttable bond, convertible or straight bond debt. Any combine of these or other financial securities would cause to consequence the same total value.

Modigliani and Miller model and its theoretical branch have encouraged significant research on capital structure. Later this investigation, many researchers attempted to verify that the inappropriateness proposal was not right and they attempted to present a more completely model. As a result, there was enough opportunity for enhancement because of the many hypothesis made in original investigation. But, the Modigliani and Miller model is not based on any proof or evidence therefore, this argument may be questionable. Because it is hard to claim that the capital markets are perfect, since there are a lot of financial securities. This variation of securities can provide sufficient evidence which the source of finance really does matter.

Even though many of the excellent literature have been empirically investigated, there has been still small debated on how firms select their capital structure. Up to the present moment, most experimental examination on capital structure inspects one of the two standard theories. They are the trade off theory and the pecking order theory. In addition, the agency and the market timing theories are also important theories in capital structure of firms.

Trade off Theory

According to Trade off theory, corporate income is taxable base in most countries. The main key point is that, interest paid on debt is tax-deductable expense. In other words, some expenses are known non-deductable expenses and others include deductable expenses. In order to determine taxable income, only tax deductable expenses can be subtracted from total income. Therefore, companies prefer financial transactions with debt rather than equity, because it raises the total after tax return to shareholders. On the other hand, if we consider double taxation principle, for instance profit tax and dividend tax it is clear that debt is more beneficial than equity. In sum, the core function of these decisions is to maximize the value of shareholders' wealth. The trade off theory is based on this fact and it claims that the amount of debt enhance assist to reduce taxable amount. But keeping too much debt causes to

enhance the cost of financial distress. Thus this theory is bottom of the common theory of capital structure because tax assumption is not adequate for supporting debt. In general, trade off theory proposes that companies aim to choose a target which creates optimally balance between costs and advantages of borrowing. The fundamental trade off theory was a consequence of the debate around the Modigliani and Miller model.

The quantity of debt could be contrary related to bankruptcy and financial trouble problems costs (Miglo, 2010). When bankruptcy costs would not be real, in this situation a company facing bankruptcy would not observe any alteration in the company total value. The value of safety is the equal, despite whether bankruptcy could happen or not under few specific circumstances (Stiglitz, 1969). Even though, financial distress problem costs exist and could be separated to indirect and direct costs. The direct costs may involve transferring the financial assets to the junior owners, fees for auditor reports, fees for managerial staff, and fees for legal purposes. Indirect costs are created when workers make decision about going on their work in another place because the company faces a bankruptcy. In sum, the company can face various problems, and suppliers and customers that believe in continuous transactions might lose trust in the company.

If tax rates increase it will also affect to increase in the company's value of the tax shield. A firm can deduct the interest payment from its income, so taxable income and tax liability will reduce. As a result, this consequence cause to an increase in leverage. The empirical proof of this comes from Graham and Harvey (2001) show that approximately half of the CFOs consent that tax factors play a major role in determining their decisions about leverage ratios. In contrast, Wright (2004) provides proof that the corporate debt ratio barely do not change over time, however, the period (1992-2002) covers many various tax rate levels.

In the trade off model, the issue between tax shield benefits and financial distress costs, lead to form an essential link with profitability. Anticipated is that bankruptcy costs are not higher for more commercial companies and tax shields are more worthwhile therefore they can generate more earnings. In finally, the trade off model anticipates these companies sustain higher debt ratios. This connection has been comprehensive investigated and in contrast, most researches get a negative correlation between debt and profitability ratios (Titman and Wessels, 1988). However, the trade off theory can't make clear this relationship, it is compatible with the empirical studies of other major factors on leverage. For instance, it supports that there are differences for borrowing between companies with more tangible assets and companies with more intangible assets because of risk.

In sum, the trade off theory is the most primary assumption of capital structure used in researches, but the practical appropriateness of this has often been debated. Miller's opinion is that the balancing between tax advantages and financial distress is incorrect, may be taxes are large and certain but bankruptcy is unusual. He supports this point by stating that if the model was right, then firms should have more leverage than view in reality. Even though the theory's forecast about profitability and debt is wrong and the proof on the impact of tax rate on capital structure is unclear, most evidence promotes the main studies of the trade off model.

The pecking order theory

Most companies analyze the pecking order theory and trade-off theory in order to investigate corporate financing decisions. They prepare three models which are based on the factors of leverage, the connection between leverage and dividends and the corporate investments. The consequences of first two factors promote the pecking order theory over the trade off theory. On the other hand, the consequences of last model are ambiguous. Thus, conclusion shows that, the pecking order model can clearly explain financing behavior of these companies. According to the pecking

order theory companies focus on a financing hierarchy devise to reduce adverse selection costs of safety insurance. This theory was initially proposed by Donaldson in 1961, but it was famed by Myers and Majluf in 1984. The conventional pecking order theory described the priority for internal funding over external funding by issuing and transaction cost. Equity issues require more transaction costs than debt issues, on the other hand retained earnings require a few transaction costs. In contrast, according to reformed theory, Myers claims that equity is less beneficial source of financing not only transaction costs but also asymmetric information. He explains that, if management issues new equity then the investors will believe that managers overvalue the company and they want to take benefit of this over valuation. The pecking order theory mainly states that the cost of financing raises asymmetric information which results in adverse selection. In this theory, developed companies prefer to use internal reserve to avoid adverse selection and moral hazard problems. Signaling is a core factor in the pecking order theory. The signaling proposal claims that when managers make financial decisions such as capital structure decisions it could also send signals to investors about asymmetries. The signaling model posits that only small and medium companies would issue equity and sane investors would forecast this. That's why these investors will demand concessions that costs will be carried by the internal investors.

In reality, the pecking order theory could not make clear avoiding in the financial results of the asymmetric information between shareholders and managers. Because, in most case some special information are available for managers, but investors receive this information only some period of time. In this case firm can issue deferred equity securities, which these kinds of securities do not convey any information and therefore managers have not got idea about the future share is high or low. The experimental studies on this model are not obvious. Shyam-Sunder and Myers (1999) propose that the pecking order model has much larger time line descriptive power than the trade off theory. However, Leary and Roberts (2010) come to a finish from

different approach “although the categorization capability of the pecking order changes considerable depending on whether one defines the hypothesis in an exact or liberal way, the pecking order can never precisely classify more than equal part of the noticed financing decisions”, thus providing proof for the decline of the pecking order theory.

There have been some differences between the pecking order model and the trade off model. The reason in favor of the first model with respect to the second model is that, this theory can make clear the negative correlation between debt and profitability. It is obvious, high profitable companies can provide with money their investments by their own retained earnings, because they can gain more revenue than less profitable companies. Thus, less profitable companies prefer to use external funds such as debt in order to invest in projects.

In sum, both of these theories, the trade off theory and the pecking order theory are based on assumption which the supply of capital is completely elastic, thus suggesting that the capital structure is only determined by a firm’s demand for debt. In addition, there have been other impractical arguments which assume that supply side elements can be appropriate for corporate leverage ratios. In recent times, Antzoulopos et al. (2014) provided fact which along with company and industry specific elements, indeed economy wide supply aspects affect the corporate capital structure.

Implications of the Pecking Order Theory

The pecking order theory has got various significant implications:

– First, no target capital structure. Due to the pecking order model, there has been no target and ideal financial leverage ratio. Rather the companies’ capital structures have been determined by their need for external financing that commands the quantity of debt the companies will have.

– Second, profitable companies use less debt. The main reason is that, profitable companies have got greater internal cash flow, thus they will need less outside source of financing and for this reason have less debt

– Third, companies can want financial slack. In order to avoid issuing new equity, companies can want to stockpile inner generated cash. This kind of cash reserve is called as financial slack. It offers managers the ability to provide with money projects as they seem and to carry quickly if important.

Agency Theory

Agency theory assumes that agency problems can influence capital structure from two various perspectives, either the connection between managers and shareholders or the connection between bondholders and shareholders. Agency cost increase when the managers do not perform in the best interest of shareholders. The fundamental agent connection also keeps for the interaction between bondholders and shareholders in this case, shareholders represent the agents. The consequence of this conflict causes interest to make debt less valuable and thus diminish the inducement to issue debt. Imagine that managers perform in the interest of shareholders and at the same time the risk of default is considerable. The managers will be tempted in taking performance which carries wealth from the bondholders to shareholders. In order to get this actions there have been several strategies. First of all, a phenomenon that consider to increase the asset substitution influence. It may be that company carry out some projects which are in negative net present value. This argument is based on the detail that shareholders gain if the project takes on yields with high returns and bondholders carry the results of the loser of the project. In sum the asset substitution influence (Jensen and Meckling, 1976) means that shareholders may gain benefit from high risk investments while these investments' value are decreasing and bondholder carry the negative settlement. In second assumption, managers could seek to take additional debt and disburse cash to the shareholders. The result of this is the same total shareholder value, but the value of debt in existence is a lower. In

conclusion, the reduction in the value of shares is less than the cash obtained for the shareholders. Finally, companies might deny some projects with positive net present value. Debt collective is the condition of the company when it has high amount of debt that it barely take any more borrow money, even the new borrowing goes to a good investment which could return more than its initial expenses. The consequences of too much debt are that any gaining received by the new project is assigned existence debt holders. In addition the company cannot issue new secondary debt because of high default risk. Furthermore the shareholders also do not seek to issue new stocks because they will carry portion of the loss that or else would have been carried by the secondary debt holders. As a result, the company does not accept and implement projects with positive net present value since it cannot to fund them.

Bondholders are clearly informed of these kinds of agency conflicts and they seek to manage them. To solve some agency problems between bondholders and shareholders, various strategies exists. For instance, while using bank loan the monitoring quality of creditor increase, since bank loans in actually are better monitored, and thus companies have less chance to accept and implement value declining projects. Another good example of this is to make use of convertible debt. This condition gives the lender the choice to change the debt instead of shares. As a result, lender can utilize debt with some financing, covenant, dividend and asset. If the companies break these covenants, the lenders are permitted to interfere in the companies. The benefit of these strategies makes debt more appropriate and much safer to issue.

Managers and shareholders' interests are not coincided with each other in some cases and it leads to various adverse results. Managers focus on their own benefit, and try to obtain better contract circumstances such as higher salaries, job security and luxury products. Furthermore, they want to enhance their position by using companies' fund. The shareholders also take some measures in order to supervise the managers'

actions. Monitoring and controlling are some of the effective ways to solve these problems. Even though the perfect monitoring such as external auditing is very expensive, but its advantages are beneficial. Shareholders seek to align the objectives of the manager with the objectives of the company by making a certain compensation agreement. However, this method cannot be perfect solution, because, in most cases managers never accept the total negative results of managerial performances. In other words, there has not been a clear and noticeable measure of the managers' activity, while the performances which are carried by managers might account for only a small portion of the company value. This causes to make it difficult for shareholders to award the members of management on special characteristics such as good investing decision making and commitment.

In conclusion, the agency theory based on the assumption which states that shareholders, managers, and bondholders have different objectives and interests, the consequence of this action cause to increase conflict among them.

The market timing theory

In recent times, Baker and Wurgler (2002) have devised a modern theory of capital structure. The market timing theory claims that the current capital structure of company is the cumulative consequence of previous attempts to time the capital market. For instance, when company believes that the shares are overvalued, it issues new shares. On the other hand, when company believes that the opposite is true and shares are undervalued, it repurchases own shares. The authors posit that the market timing model is the primary command determinant of companies' capital structure. In actually, companies is not interested in their source of financing is equity or debt they mainly focus on sources which seem more valuable in financial market at that moment. Most of the empirical proofs support this argument. Baker and Wurgler defend their theory by claiming that an index of financing which make known how much financing was done throughout called the hot equity periods and how much

throughout the hot debt periods. More evidences have come from Huang and Ritter (2004), who have found that public traded companies which fund a higher proportion of financing decrease with net outside equity when the anticipated equity risk is lower and when the earliest days' returns of the initial public offerings are larger. However experiencing the persistence of the influence of the market timing disclosed as hot market initial public offering companies issue significantly more equity and smaller debt to asset ratios more than cold markets companies do. Nevertheless, later going public, hot market companies quickly raise their debt to asset ratios related to issue more debt and less equity relative to cold market companies. The consequences of the second year show the influence of market timing on leverage entirely disappears (Alti, 2006).

The proposal seems to be quite reasonable. However, the theory does not state adequate information about factors which are conventionally considered to influence the capital structure. For instance, it could not have clarified the negative connection between profitability and leverage. It only proposes that companies pursue to issue equity when the capital market has found relatively convenient or companies decrease their leverage ratios when the loan market situations are relatively inconvenient.

In conclusion, none of these theories could have explained capital structure independently. Even though the agency theory hold lots of intuitive and substantial ideas, it is really difficult to measure the total impact of agency problems on the capital structure. Although, the trade off theory could have explained plenty facts in capital structure, it has faced with problem that consider to describe the negative connection between debt and profitability. However, the pecking order theory could have provided an obvious answer for this connection, but there has been no coherent opinion to make clear the obscure empirical evidence.

Many investigations have also analyzed the influence of internal factors on the capital structure. The capital structures have been explained by many fluctuating arising from trade off, agency and asymmetric information considerations (Booth et al., 2001). Regressions have shown that among variation is much larger than throughout variation of capital structure (Lemmon et al. 2008). Therefore many of the variation of leverage ratios could have explained by cross sectional distinction instead of time series variation.

The pecking order theory anticipates a negative correlation between financial leverage and profitable. More profitable companies could provide money their investment projects with their own earnings and were not required to issue any debt. However, less profitable companies have not got other choice than to use debt, thus probably profitability has got a negative influence on leverage. Most of the literature approves that the negative connection between leverage and profitability level (Danbolt and Bevan, 2002; Wessels and Titman, 1988). Due to the trade off theory, there could have been a positive connection between financial leverage and profitability. The tax advantages for profitable companies are more beneficial and costs of bankruptcy are lower, thus anticipating higher debt levels. This discussion could somewhat be moderated by considering the influence of individual taxation. Furthermore, interest tax shields might be insignificant to firms with other tax shield, like depreciation (Masulis and Deangelo, 1980). In contrast, most of the conclusions do not support that positive contact and are systematic with pecking order proposal by approving the negative connection (Zingales and Rajan, 1995).

The trade off model proposes that the ideal financial leverage ratio stabilizes the advantages of tax shield of debt and growing the cost of agency and financial distress. Due to the financial distress context, as great companies are more expanded they are anticipated to get bankrupt less than smaller companies, thus they could manage higher leverage degree before facing great bankruptcy costs. Furthermore, as

companies grow in size the probability to have the credit rating raises. The credit rating presents a company to acquire non bank borrow financing that is usually inaccessible to little companies. Both arguments forecast a positive connection between leverage and size. Nevertheless, size may also be the proxy for information accessible for external investors, which should raise their priority for equity relation to debt. In contrast, empirical evidence defends the positive correlation (Danbolt and Bevan, 2002; Daskalakis and Psillaki, 2009).

Agency theory has suggested that highly levered companies tend to underinvestment or venture suboptimal and therefore diminishing the bondholders' wealth. That causes creditors to demand collateral because using safety debts could help mitigate this complication. In this case, tangibility can be regarded as some type of security collateral. When the tangibility of assets raises, the liquidation value also increases and the possibility of mispricing in condition of bankruptcy reduces. Thus companies which are not able to present collaterals get borrows at less convenient conditions or will be compelled to issue equity. Due to trade off model, tangibility can be seen as an essential driver of distress costs. A large amount of tangible assets move the essence of incurring bankruptcy costs exceeding. Thereby a positive relation between the financial leverage and tangibility is anticipated and approved by empirical results (Danbolt and Bevan, 2002; Rajan and Zingales, 1995).

Great growth opportunities provide inducements to invest alternative optimally or to take risky projects which transfer fund from debt to stockholders. This increases borrowing costs and thus companies with more growth opportunities move to prefer internal financing and equity above debt. This agency problem could be lessened if the company issues short term instead of long term debt. Thus, anticipated future growth might be negatively connected to long term debt positions, although it might be positively connected to short term ratios of debt. The empirical consequence

concerning growth potentials and debt ratios, approves the negative correlation (Wessels and Titman, 1988; Danbolt and Bevan, 2002).

The costs that companies can potentially deceive on their customers, workers and suppliers in condition of bankruptcy are compatible to their leverage ratio. Customer, workers and suppliers of the companies which create unique or very exclusive products are more probably to deteriorate high costs in the situation that the company meets bankruptcy or financial distress. The customers might competence obstacles to find a substitute company that can present those unique products. In this case, workers and suppliers very likely have got job specific abilities and skills, which cause to make them less versatility. Due to these high costs in condition of liquidation, uniqueness is anticipated to have got a negative influence on financial leverage. The conclusion of empirical evidences supports this connection (Wessels and Titman, 1988). Competence for uniqueness is development and research expenses over sales and selling expenditures above sales. It is assumed that this ratio estimates uniqueness because companies which sell products with familiar alternatives face greater chances that their modernizations will be copied, which makes them thus less reasonable to de many research and development. In addition, successful research and development projects possibly lead to modern and special products.

The variability of company risk is a representative for the possibility of financial distress. Expectation is that it has got a negative effect on the financial leverage ratio. When the company is considered as a risky entity, the cost of debt can raise for this company, because creditors might require a risk premium. For this reason, the debt levels are anticipated to be smaller for high risky companies. Many researches approve this negative correlation (Wessels and Titman, 1988; Wald 1999).

2.2 Contemporary banking capital structure researches

Banks and other financial institutions are specialized business entities whose capital structures have been influenced by a number of terms exclusive to the banking industry, like government regulation and entry to a safety net which contains deposit insurance and borrowing means of the Central Bank. Deposit insurance was generated to maintain the quick withdrawals from the banks whose financial condition might be in confusion. As Diamond and Dybvig (1983) mention, deposit agreements which provide liquidity, which is, agreements which permit depositors to withdraw reserves on demand, are issue to bank runs. These runs are especially hazardous for banks which rely on liquid deposits in order to finance highly illiquid credits. With government deposit insurance the depositors have no inducements for a run. An alternative tool to ease the bank runs is for central bank to behave as creditor of past resort.

Previous studies of capital structure in banking have made contradictious predictions. First of all, the moral hazard theory have been claimed to forecast that banks with insurance of deposit would elect very high leverage level (Prescott and Marshall 2000, Lai and Geuyie 2003). The reason is associated with the insurance premium which does not reflect and adjust with the underlying risk of activities which are insured. In the meantime, random observations of banks' capital structure choice have shown that banks do not work with capital ratios same to regulated minimum. An insurance premium compensated by the banks for insurance of deposit is only one element of the regulatory cost connected with the insurance of deposit and other researches that suppose these regulatory costs actually assume that banks do not elect high financial leverage. Kane, Chen and Buser (1981) noted that banks could face considerable costs which are not obviously priced applicable to regulations, monitoring and investment limitations. Merton (1977) investigates the contingent proposals of bank leverage model that involves clear regulatory costs for failed banks. He demonstrates that this regulatory load could be considerable enough to

make a preference for equity within secure banks. Marcus (1984) clearly analyzes capital structure of banks under capital regulations and claims that for secure banks, raises in capital are wealth raising, however for seriously failed banks the withdrawals raise investors' wealth.

Merton (1977) patterns deposit insurance like put option, that suggests banks the right to set their funds to a deposit insurer at the worth of strike prices equal to nominal value of the depositors. The deposit insurance value increases with the risk of asset and the strike price due to option pricing theory. Therefore, the insured banks might have incentive to optimize the value of their deposit insurance by carrying more risk and applying less capital. Some supervisors observe this moral hazard problem as a debate in favor of powerful banking supervision and equity regulation. If the government protection net lowers the anticipated cost of financial suffering for banks later on due to tradeoff theory, they could have tend toward leverage more than nonbank institutions. Capital regulation might be needed to induce them to keep more capital.

These consequences are not fulfilling in the reasoning that for secure banks, these proposals assume that the contrary corner solution rather than have done the moral hazard problem and both of corner solutions are obviously incompatible with real bank capital decisions. The objective of the Marcus and Merton researches was to indicate the significance of the regulatory weight connected with insurance of deposit for bank capital structure decisions. The Marcus and Merton assumptions although omit consideration of an important advantage, the value of reasonable prospective insurance payments. However, the proposals above demonstrate the significance of both capital regulation and moral hazard problem, they have not assisted motivated policy analysis, because their assumptions are at strangeness with empirical regularities.

Repullo and Elizdale (2007) advanced an assumption of banking capital structure in which banks are pleased a franchise value connected with taking on loan with the risk free rate, however if the banks face a loss, the investors have to introduce additional capital adequate to set again their capital to the optimal beginning of period ratio and if the loss serious enough, the banks are discontinued by the owners or regulator. Even though, Repullo and Elizdale (2007) assumption permits the banks to independently recapitalize every term undoing the supplementary risk of dissolution made by a ranks of negative collapse. Due to their assumption, banks have not been required to plan forward for the risk connected with the probability of multiple terms of negative collapse which slowly consume the bank's capital condition. The current financial crisis underlines the significance of taking into account proposals that do not permit for recapitalization of financial institutions in response to negative collapses.

Leland (1994) has developed the common model of capital structure by providing broad framework of banking capital decisions on the point of a deposit insurance order. Leland receives an exclusive form expression for the perfect capital structure of a company which issues risky debt in participation of bankruptcy costs and also tax preference debt. In that model, it is important to consider a condition where a bank could borrow or receive deposits with risk free rate because these deposits are secured by the government, however, the banks might face an insolvency threshold which is created by the regulator in case of capital regulations require bank's liquidation when the capital adequacy ratio declines at the bottom of the threshold. However, Repullo and Elizdale (2007) model express a balancing of costs and benefits which result in an internal solution, as Leland's model, banks face former decision with regard to capital structure. Since this might initially sound excessively restricted, there have been considerable frictions that avoid continuous capital rebalancing and many banks cannot return to the market cycle after term to recapitalize the bank on reply to losses, particularly in case of economic recession.

Therefore, it is significant to consider the condition, when banks determine capital structure they also have to plan unfavorable economic environments in terms of capital cannot be simply raised.

Investigations have found that there is an inner ideal capital ratio in banks with a tax advantaged debt, minimum required capital and deposit insurance. Thus, the banks willingly choose to keep capital more than the required minimum. It does not mean that the minimum authorized capital requirements are inefficient and useless. Strict authorized capital requirements intimidate all banks with the possibility of losing the worth of their equity when the bank infringes the requirement as the consequence of incidental fluctuations in assets value. Therefore, banks seek to choose capital ratios higher than the minimum requirement in order to increase as much as possible the anticipated value of their equity wealth. If there have been no authorized capital requirements, the banks would elect a curve solution with very large financial leverage. For this reason, the actual function of capital requirements are to generate a cost of bankruptcy that substitutes the insolvency costs in the founding of an ideal corporate capital structure.

The tax advantaged debt is core to the existence of the inner ideal corporate capital ratio. Insolvency costs and benefits of insurance are minor corresponding to the tax benefits and change together with variations in deposits, since tax benefits generate a great franchise value which is set on risk by capital regulation. That conclusion is related to consequences of Hellman, Stiglitz, Murdock (2009) and Marcus (1984) who report an essential role for franchise value in perception the influence of capital standards on the risk taking treatment of banks.

The banking capital structure theories have developed increasingly since the last decades. Especially, Rajan and Diamond (2000) created a new pattern for capital structure in which case of assurance banks utilize deposits only to provide with

finance their projects, however under an unsureness situations the cost of runs inspire the utilize of other source of external capital. Raised bank capital diminishes banks' liquidity but allows them to exist and to avoid financial trouble. The ideal capital choice decision trades off banks liquidity, financial distress cost and the mitigation of inducing repayments from creditors. Allen et al (2011) examine the surplus capital that banks keep, and how it is anticipated to defend market regulation and system constancy. Their proposals mainly focus on asset aspects and indicate that when financial markets are advanced competitive to involve more creditors and at the same moment inducement monitoring banks elect to utilize expensive capital rather than rise interest on loans.

Admati et al. (2013) investigated the debate that equity is costly and great capital requirements are expensive for large banks. They have found this opinion to be poor and defended by poor arguments from managers and investors who have powerful inducements to hold high leverage. Alternatively, they claim that when banks keep more equity capital, risk premium reduces thus diminishing the required rate of return on equity that in turn diminishes banks' costs. Due to their opinion banks with higher capital can face a fewer misrepresentation in borrowing decisions and enhance their performance.

Miles et al. (2013) defend Admati et al. (2013) and seek to estimate the perfect capital structure for banks. They have found that large amount of increasing in equity can result in lower long period raises in borrowing cost that faced by purchasers. In contrast, thoroughly greater capital requirements could have resulted in significant benefits by diminishing the risk of relating to an entire banking crisis.

Thakor (2014) gives a common model of the banks which maintains quality of asset alteration and elects their capital structure. This assumption is utilized to make clear the connection between bank capital and constancy and it also applies different

theories of banking capital structure. Furthermore, the research revises the theoretical and empirical argument in the literature on the banking capital. The author claims that it is empirically confirmed that higher capital is connected to raised lending, raised making of liquidity, raised stockholder value in banking and raised possibilities of remainder in financial crises, however lower capital may carry on systemic inconstancy and raised government borrowing resulting in bailouts and autonomous crisis. The research provides thorough debate on how regulation could improve banking constancy and claims that financial intermediaries must be required to keep more capital in order to ease risks.

In recent times, Allen et al. (2015) enhanced a composure common capital structure proposal with bankruptcy cost. Moreover, their proposal diversification is a substitute to keeping equity capital in diminishing the cost of bankruptcy. They claim that it is ideal and more beneficial for banks to utilize costly capital as corporate creditors promote dealing with banks which have got higher capital and for this reason have got more inducement to check them. The authors emphasize the need for more researches on banking capital structure in order to assist banks to make better decision on their capital

There have been other theories which debate how capital influences the liquidity making of banks, lending and owners value. Some of them claim that higher capital raises banks' efficiency and effectively in assets allowance thus growing lending and liquidity making, and inducement more checking and for this consequence higher owners value (Thakor and Mehran, 2011). Others state that higher capital reduces liquidity, raises costs and for this reason lower level of lending and liquidity making (Rajan and Diamond, 2001). Nevertheless, these theories agree with the influence of banks capital in supporting related to an entire consistency.

In general, empirical literature in the determinants of capital structure in banking examines two preference views, first view is known as the corporate finance view that carry on conditional determinants of capital structure have found essential for non financial companies to banks. The second view is known as the buffer regulatory view. Due to this view banks keep the buffer capital over the minimum authorized capital requirement on order to prevent the high costs connected with issuing equity capital in concise review in case of any infringement of capital requirements.

Many banking researchers mainly focus on the exclusive activities of banks, like liquidity creation and credit extension. According to Diamond and Rajan (2002), the capital structure of banks could have influenced these activities. Banks could create liquidity due to offering demand deposit. Since raised confusion could subject deposits to quick withdrawals, external capital could play a role by diminishing deposit volatility and enhancing a bank's ability to remain alive. However, due to definition the higher capital level conserves a reduced necessity for deposits and for this reason less liquidity creation.

The capital structure theories could assist to explain the choices banks have made on increasing the capital during the disastrous financial crisis. According to the pecking order theory, when banks have got secret information about their financial assets, they could elect to issue debt earlier than equity to reduce the undervaluation problem. However, during the financial crisis the banks needed to increase equity in order to replace depleted capital. At the present time though, the asymmetric information related to bank asset portfolios was very serious which equity could actually have been issued only at a significant discount. In this kind of environment, issuing preferred stock could have been an appropriate strategy because it escaped diluting common equity during reinstating the optimal balance of debt and equity financing and also meeting statutory capital requirements. Furthermore, issuing new common equity in a discount could have relocated fund from existing to new

stockholders. And, issuing new debt could have raised the possibility of default, which the connected with the risk of losing manage rights. Contrasted with the debt service payments, the dividends of preferred stockholders could be postponed without triggering bankruptcy. The main reason is that, debt claims are senior to preferred stock claims and investors could require the higher rate of return. The banks could have issued convertible preferred stock that presents holders the right to change preferred shares to common stock at a predictable price in order to reduce dividends. In fact, the issuing company is presenting the preferred shareholders a call option in the company's common shares as an exchange for a lower dividend payment.

2.3 Country specific determinants of capital structure

Previous researches have provided evidence that companies' capital structure is not only influenced by internal or firm specific factors but also by country specific factors. Antzoulatos et al.(2014) claim that the institutional environment has a significant impact on capital structure decision. They support this point by stating that spreading to cross country setting could have provided a perfect venue to investigate the relative significance of institutional variables influential leverage. This could have been an important contribution to a modern and enhancing literature which investigates the institutional determinants of corporate leverage. In addition, many investigations have shown that institutional environment leads to companies' behaviors varied of financing policy throughout countries. Especially, Maksimovic and Demirguc Kunt (1999) claim that the great difference in the using of borrowing between developed and developing is due to the inconsistency in an institutional environment. Gianetti (2003) states the influence of some institutional aspects in the capital structure of companies in different countries. Twite, Titman and Fan (2012) have found that the legal system of country and the advantages of capital suppliers make clear an important portion of the variety in financial leverage and debt ratios. However, these researches consider country fixed impacts within dummy variables,

this point of view still deceives an equality of coefficient of interpretive variables throughout countries.

Shareholder protection

It is anticipated that, shareholder protection probably has a negative correspondence with agency problems costs. In some companies where the rights of shareholders are lower, it is probable to experience a broad difference of ownership and control that increases the possibility of agency problems. This connection is used by Jirapron and Gleason (2007) to examine the connection between leverage and shareholder protection. Because, the leverage is linked to agency costs and agency costs are connected with shareholder rights, they propose that the intensity shareholder protection has an influence on a company's capital structure. Companies with smaller shareholder protection could adopt higher leverage ratios to ease higher agency costs between managers and shareholders. Jirapon and Gleason have provided empirical proof for this opposite relationship in the end. But they could not have found proof for this negative connection in regulated companies. They claim that regulation has already helped to ease agency problems and thus diminished the role of debt in decreasing agency costs. Further proof on this reverse connection between leverage and shareholder protection has been provided by Cheng and Shiu (2007), their research consider the fact that countries with well shareholder protection have used more equity funding as a source of finance that causes in a lower leverage ratio.

Creditor protection

Determining creditor rights is more complicated than the assessment of shareholder rights. This is caused by the fact that there have been plenty different types of creditors with different objectives therefore, protecting one creditor's rights might be inconvenient for another. There have been two common creditor strategies for companies when they are faced with defaulting: reorganization and liquidation. Each one of them involves various creditor rights in order to be efficient.

Ghoul et al. (2012) propose two opinions regarding the influence of stakeholder protection on capital structure. First opinion demonstrates that creditor protection as a stakeholder protection has a positive influence on the debt level of the company. This opinion concerns the supply side of the capital markets. The argument is that powerful creditor protection causes lenders to provide credit with more convenient circumstances which result more use of loans by companies. This could be proved by agency theory which considers that agency cost reduces with the creditor protection. If the creditor protection is not high, stakeholders will be able to face asymmetric information and adverse selection costs. As discussed before the agency theory stated that there has been a conflict between bondholders and shareholders. Shareholder may refuse projects with positive net present value or take negative net present value projects. When the creditor is more preserved, the supervision on the company will able to be better and it would be more complicated for a company to carry out negative NPV projects. As a result, debt is more worthwhile and the inducement to issue debt will be larger in higher creditor protection countries. This assumption is supported by the discovering of Cheng ad Shiu (2007), where they have found a powerful positive impact of creditor protection on the leverage ratios.

The second opinion is based on demand side of the capital market, anticipates the opposite which considers creditor protection has a negative influence on the debt level of company. It proposes that strong creditor protection does not encourage shareholders and managers to use immense amounts of debt because they seek to avoid losing power in the situation of financial distress.

Market-versus bank oriented

The capital market is a financial market where financial institutions can increase short term and long term funds by financial transactions. The capital market includes the bond and the stock markets. Capital markets conduct savings and investments

among users of capital and suppliers of capital. The size of a country's capital market is straight connected with the size of its economy. For instance, the United States has got the largest capital market in the world, because its economy is the biggest economy in the world.

In bank oriented financial systems such as Germany and Japan, the role of banks have been great in organizing savings, distributing capital, monitoring financial and investing decisions. Supporters of bank oriented capital markets posit that bank centered structure induce to development of capital markets and long term financial planning, on the other hand, a stock market centered cause to encourage short term investing opportunities for managers. Defenders of stock market centered system highlight the adaptive factors of the market for corporate regulate that are deficient in bank oriented systems, in addition they refer to the absence of empirical proof towards their short term conditions. Law is also an essential determinant of the banking development. In some countries where the legal system highlights stakeholders rights and enforces agreements have well developed banks rather than countries where statutory does not treat to creditors as important and where enforcement is slack (Levine, 1998). In addition, countries with a standard law tradition, good auditing regulations, powerful protection of shareholder rights and no specific deposit insurance are more inclined to market based (Demirguc-Kunt and Levine 1999). In the market oriented systems such as the UK and the USA securities markets play a major role in relocating the society's savings to companies, applying corporate regulation and facilitating risk management. In sum, the category of oriented market has an impact on the capital structure decision and the leverage ratios are various between the two kind of markets (Antoniou et al., 2008).

In contrast to Antoniou et al., Rajan and Zingales (1995) have not found any organized difference between the degree of leverage in the market oriented and bank oriented countries. They put forward the question whether bank orientation is a

worthwhile feature and whether the immensity of importance of banking sector affects the company's financing decision in any way. Finally they conclude by claiming that it emerges that the disagreement between bank and market oriented countries is revealed more in the option between stocks or bonds and bank loans than in the size of leverage.

Fan et al, (2012) obviously consider the capital supplier context and advantages as determinants of the companies capital structure decision and involve a series of supply side variables on the financial leverage explanatory proposal like proxies of the supply reserves available to the different financial institution such as commercial banks, insurance companies and pension funds.

Inflation

Inflation also might influence corporate capital structure. Higher level of inflation result in more pricing power for businesses and this in turn raises the businesses' earnings and their ability to return their obligations (Jain and Kamp, 2010). Therefore these authors anticipate and approve the possibility of lower incidence of default when higher inflation occurs. Referring back to the trade off theory, inflation could be observed as a financial distress. The main reason is lower possibility of default is predicted to raise the leverage ratio and inflation is anticipated to have a positive influence on corporate capital structure. The impact of inflation on debt financing decisions has been approved by Prezas "Inflation, Investment and Debt" (1991), where he has concluded that inflation could influence the leverage in two ways, indirectly and directly. It is connected with the impact of inflation on the value of interest tax shields, marginal depreciation factor, and on the possibility of accounting loss. Inflation influences the leverage ratio indirectly by its interaction with tax factors. In tax exempt companies, inflation could not influence optimal debt and investment, on the other hand, if it concerns a taxable base company, higher inflation

rate does not affect significantly the choice of optimal debt level but diminishes the optimal investment.

There have been many country specific factors which could affect the capital structure with two ways, indirectly and directly (De Jong et al. 2007). For instance, a more advanced financial market system induces companies to issue equity and thus keeping on lower level of debt. In addition, these kinds of factors could also affect the issue of firm specific variables on the capital structure. The influence of more advanced bond market is that, it causes to issue bond more attractive, although it indirectly affects the tangibility of asset's role as collateral in lending and the use of debt already instigated therefore the influence of tangibility asset in proposal declines.

Kunt-Demirguc and Maksimovic (1999), claimed that annual growth rates in states GDP is an index of the financing requirements of companies, that causes a positive influence on the utilize of debt. The formation of capital can influence corporate financial leverage both negatively and positively. The collection of more retained earnings encourages less dependence on borrow usage, on the other hand, it can also create more financial requirements and thus a greater need to use outside source of financing.

Measurements of capital structure

Different measurements of financial leverage have been used in the capital structure researches. The dissimilarity come from the characteristic of debt, is it used short term or long term and is it convertible or not, these elements cause to difference. In addition, there has been a distinction in applying book value or market value of financial assets or equity. It is tough to conform all of them into common debt ratio. Some theories seek to clarify that determinants of capital structure have been anticipated to connect with the various measurements of leverage. For example, great

growth opportunities provide inducement to spend money sub optimally or to take risky projects which carry funds from debt to shareholders. As a result, this increases the cost of borrowing and that diminishes the inducement to use debt. However, this agency problem could be eased if the company issues short term debt instead of long term debt. Thus, growth opportunities are anticipated to be negatively connection with long term leverage and positively connection with short term leverage. In addition, convertible debt might rise by the level of higher growth opportunities. Convertible debt could be seen as a safety form of debt. The creditors have got the opportunity to change their debt towards stocks. Although the fascination of the potential reformation is much greater for high growth companies, the relevant costs of issuing this kind of debt are lower. Thus, it is anticipated that there have been greater ratios of convertible debt in direction of assets for companies with greater growth opportunities.

3. Methodology and Results

3.1 Methodology

The main objective of this study is to identify and to prove the direct and indirect effect of country characteristics on banks' financial structure. In this research, secondary data and quantitative method are used in order to investigate the influences of country factors on capital structure of banks in Azerbaijan. These data have come from the five commercial banks' statements of financial positions for 31 March 2018. They are Pasha Bank ASC, Kapital Bank ASC, Xalq Bank ASC, AccessBank QSC, and ASB Bank ASC. In order to examine their capital structure, debt-equity and financial leverage ratios are analyzed, because these indicators can clearly demonstrate the main implications on capital structure. These banks are elected regarding to their various characteristics. Information on their balance sheets and income statements is available and relevant for users. Therefore it is effective to analyze and determine main issues about them. It is adequate to focus only on the five commercial banks in order to get result to our argument and these five banks' financial reporting information is enough to prove that country specific factors affect the capital structure of all banks. Because they are the largest banks due to their asset and credit portfolio in Azerbaijan, moreover they are dominant banks and their position can represent all Azerbaijani banks. In addition, some of them are working under the foreign capital, such as AccessBank and therefore the impact of country specific factors on its capital structure is more reasonable. In sum, this study have shown that the role of statutory regulation are significant in the impact of Azerbaijan.

Capital regulation of banks

The capital requirements of banks have grown an increasing degree in recent times in Azerbaijan and generally involve a requirement to keep capital which inflects the risk of the disclosures held by the bank named risk weighted assets. There have been two

classification of capital are determined in the regulations, they are Tier I and Tier II. The Tier I capital includes common stock, paid in capital, noncumulative preferred stock, retained earnings and certain other elements. The Tier II capital involves Tier I capital addition cumulative preferred share, loss reserves, subordinated debt and also other debt instruments which are subject in priority to deposits. Due to Basel II, the banks have to maintain Tier I capital which surpasses four percent of the risk weighted assets and the overall Tier I and Tier II capital which surpasses eight percent of their book value of assets. In Azerbaijan, the Central Bank and the Financial Market Supervisory Authority are regulator and supervisor of the financial system. Banks have to hold minimum authorized capital in order to continue their activity. When they cannot meet the minimum capital requirement to their authorized capital, the Central Bank or the Financial Market Supervisory Authority may abolish their license. According to the Central Bank statutory rules, the minimum authorized capital has been 50 million manat since 2012. This amount can be changed due to economic situation. For instance interest rates, economic growth indicators are considered in determining minimum authorized capital. During the higher inflation sitauation this amount can be increased. In actually, statistics show that year by year this amount have increased. This trend have been observing in foreign countries and in Azerbaijan. Many banks' license have been abolished over the past three years because they could not meet minimum authorized capital. They held too much debt and lower amount of equity and as a result they could not continue their activity. This situation has shown, keeping too much debt results in negative consequences. On the other hand, to maintain more amount of equity is beneficial for banks, and it protects their safety. In conclusion, banks always consider minimum authorized capital requirement when they determine financial leverage, because making wrong decision in capital structure raise financial risk and it can result in worse consequences.

The impacts of Azerbaijan tax code

Accoring to the Azerbaijan tax code, interest expenses are deductable expenses from banks earnings when computing a bank's profit tax. Therefore each manat of interest payment results in a savings on profit taxes for a taxpaying bank and this is directly connected with dividend tax. In order to determine the profit taxes, firstly taxable profit have to be computed. Accoring to the Azerbaijan tax code some expenses can be deductable expense for computing taxable profit and others are undeductable. Therefore, banks have to prepare both tax accounting and financial accounting at the same time, because total profit might be different in financial accounting and tax accounting due to type of expenses. As a result, interest expenses as a deductable expenses reduce the total amount of profit. Thus, taxable profit also decreases and banks pay less amount of tax. It is also important to consider double taxation principle. According to tax code, shareholders of banks have to pay 10% of dividend tax. Moreover, banks have already paid 20% of profit tax from their profit and they will also pay 10% of dividend tax from their net income. It is very clear, this double taxation principle influence debt and equity choice, thus banks prefer more debt. This research have found that one of the main country specific factors which affect capital structure of banks is double taxation principle. Especially 10% of dividend tax rate is higher for shareholders of bank, because both profit tax and dividend tax increase total cash outflow and as a result, shareholders' wealth reduce. In conclusion, these evidences show that the role of tax factors are great in banks' financial position.

The impact of agency costs

This research also has found that there have been the agency costs between bank managers and shareholders. With agency costs, bank directors are assumed to have inducements to raise their own welfare by the costs of investors. The main problem is that how can motivate executives to emit money rather than spending it on squander ways which are beneficial for them, but cannot meet hedge rates of return, like

buying private jets or expensive office decorations. The answer could be borrowing, that forces banks to pay out cash. Therefore, while a high financial leverage ratio could increase the probability of financial distress, it could also enhance value by inhibiting directors from making unprofitable and useless investments. In Azerbaijani banks, there have been significant conflicts between shareholders and directors of banks. Because, directors and executive staff mainly interested in their own objectives and they assign high salary and reward for them which results increasing in operating expense and cash outflow.

In less developed capital markets there has been less information about companies or banks' financial position for various reasons like illiquidity market, weaker supervisions, and poor corporate governance standards. Therefore, this infers more asymmetric information among external users such as investors, customers and internal users like managers, executive board, resulting in increasing the cost of capital. As a result, the development of capital market with regarding to both turnover and liquidity has a negative influence on the financial leverage. Nevertheless, it is also possible to assume a positive impact on the financial leverage regarding to liquidity and the turnover of stock exchanges, while the capital market liquidity and the turnover of stock exchanges enhance companies' transparency form the creditor' standpoint and this influence could be improved when the state's statutory and law framework is strong. In sum there have been two propositions about capital market.

– First, the development of capital market has got a negative direct impact on the financial leverage.
– Second, the liquidity and turnover of capital market have got a positive indirect influence on the financial leverage, which intervened by the law and statutory environment.

In this research, Baku Stock Exchange represents the stock market in Azerbaijan. The turnover of Baku Stock Exchange shows that it is not known as developed stock market yet, in other words it does need to improve. Therefore banks do not tend to use financial transaction in Baku Stock Exchange. Trading in Stock Exchange is not beneficial for banks. So, they prefer other financial transaction. In addition, the development of banking sector positively influences to the other industrial companies' leverage, since companies have got many borrowing alternatives and there has been more competition among banks, which result in lower costs of financing and higher efficiency on electing borrowers, decreasing the adverse selection problem. In sum, the development of bank sector has a positive direct influence on the companies' financial leverage.

The level of protection of stakeholders' rights, both shareholders and creditors affects the decision of capital structure choices. In this case the main key point is that, however the protection of creditors' rights has got a positive direct impact on the financial leverage, in contrast, the protection of shareholders' rights has got a negative direct impact on the financial leverage. However, when it is proposed by the demand side context, the better protection of creditors' rights means great cost of trouble and bankruptcy for the lenders which could be more seriously disciplined if they cannot carry out their debt obligations. Thus, in this situation, banks may ask for less borrow, confused by the higher factual default costs. To be similar, when agent principal proposition is less important, banks may use more borrow, because the shareholders' interests in advantage from the tax shields passes the risk diminishing context of managers or major shareholders, furthermore, as for closely held banks are concerned, if investors have been more protected, reluctance causes the most shareholders prefer debt to equity. As a result, in contrast, the protection of creditors' rights has got a negative direct impact on the financial leverage and the protection of shareholders' rights has got a positive direct impact on the financial leverage.

The protection of creditors rights is similar to lessen the influence on the financial leverage of some internal determinants. High protection of creditors' rights lessens a negative influence of operating risk and a positive influence of asset tangibility on the financial leverage. Thus, when statutory and its impositions present a good protection to creditors, the bank system is similar to give more borrow to companies with poor collateral and hopeless returns. In conclusion:

– An operating risk, lessened by the creditors' rights protection has got a positive indirect influence on the financial leverage, which partially refund its negative direct influence.
– An asset tangibility, lessened by the creditors' rights protection has got a negative indirect influence on the financial leverage, which partially refund its positive direct influence.

It is also important to consider the mediation influence of the legal perspective which could enforce a stronger or poorer protection by the statutory system. The developed legal system means effective approaches, impartial judges, and cost efficient lawsuit. Thus it is assumed a positive direct influence on the financial leverage, supposing the compulsory nature of borrowing agreements and the residual environment of stockholders' claims. In addition, it is assumed that the quality of the legal system lessens the level of protection of stakeholders rights, improving the connected direct influences on the leveraged. In conclusion, there are three arguments in legal systems role.

– First, the quality of legal system has got a positive direct impact on the leverage.
– Second, the quality of legal system improves the direct influences of creditors' rights on the leverage.
– Third, the quality of legal system enforces the influence of stockholders' rights protection on the leverage.

There have been many bad debts problems in Azerbaijani Banks. These problems and their solvency ways is also associated with legal system, the final decision about them is determined by the legal system. Bad debts problems can result in losses and this consequence directly influence banks net income and retained earnings. Decreasing in retained earnings also cause to reduce in total equity and that's why it affect negatively to shareholders wealth. In sum, the impact of legal system in Azerbaijani banks is great and its decisions can solve banks' problems and it can improve their activity.

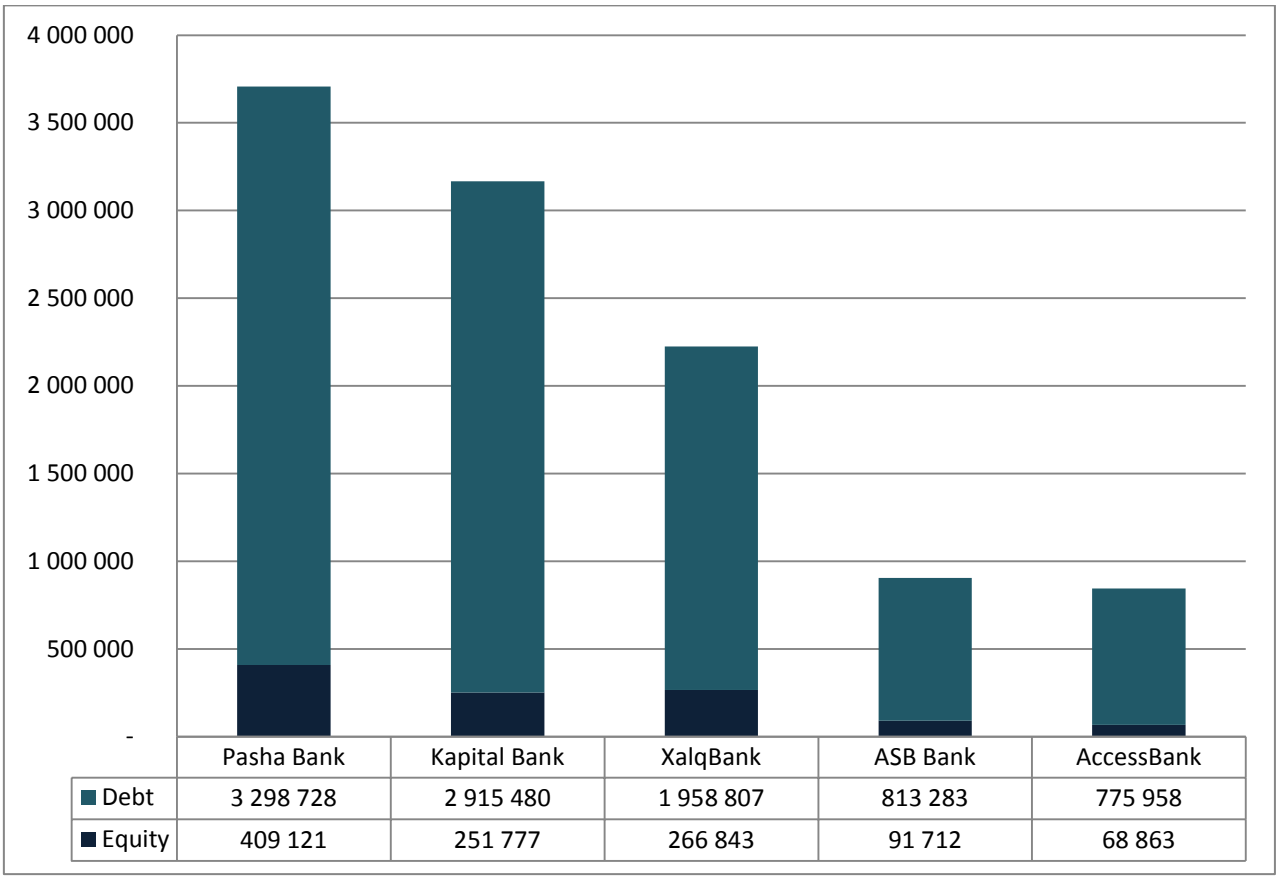
3.2 Results

In order to prove the influences of double taxation principle, agency costs and authorized capital requirements on capital structure of banks, the debt and equity information has been used which is based on banks' financial statements. The results of analysis show that Azerbaijani banks have approximately same debt and equity ratio. Furthermore, it is associated with the factors which affect to all banks with same circumstances and at the same time.

Figure 3.1 indicates the capital structure of five Azerbaijani banks. They keep more debt and less equity due to the advantages of borrowing. More borrowing are beneficial for them and it causes them to prefer debt as shown in Figure 3.1. The benefits of debt have noted above and those factors really express themselves in Figure 3.1. Banks' choice tend to more borrowing rather than holding large amount of equity, because it is not accepted as a better financial decision for them. Even though their total amount of equity is extremely large from minimum authorized capital requirement, it is important to consider their total value. They have got the largest asset portfolio in Azerbaijan.

Figure 3.1: The capital structure of Azerbaijani banks

(Numbers in figure are in thousands of Azerbaijani manats, at 31 March 2018)



	Pasha Bank	Kapital Bank	XalqBank	ASB Bank	AccessBank
Debt	3 298 728	2 915 480	1 958 807	813 283	775 958
Equity	409 121	251 777	266 843	91 712	68 863

In order to investigate the capital structure of banks, it is important to determine their financial leverage ratios. The financial leverage ratio equal to total amount of debt divided by total equity. Higher leverage ratio is known as a negative index because, in this condition the large portion of assets is debt and equity portion is small. Therefore it is also more risky and it can result in cost of financial distress. Due to the significance of determining leverage, this research have analyzed debt and equity portion with percent and financial leverage ratio.

Table 3.1 indicates the financial leverage ratios of Azerbaijani banks. All of them have high leverage indicator which is not known a better position. It can be risky, but these banks profitability is good enough and it cause to generate more retained

earning which turn to as a part of equity. There are approximately same debt level in every banks' capital structure. Furthermore, their debt and equity indicators are similar with each other. Any big differences cannot be observed and this fact demonstrate the factors which affect banks' capital structure are same and they influence at the same level. This evidence prove the main argument that consider the influence of country factors. If there have been any differences between capital structure of banks such as various debt level, it can be assumed that country specific factors do not affect directly to them. In other words the main determinats of their capital structure are other factors. But in actually all five banks' indicators almost same and it means they have same influential component.

Table 3.1: The financial leverage of Azerbaijani banks as at 31 march 2018

	Pasha Bank	Kapital Bank	Xalq Bank	ASB Bank	Access Bank
Debt	89%	92%	88%	89%	91%
Equity	11%	8%	12%	11%	9%
Leverage	8.06	11.57	7.34	8.86	11.2

The consequences of this analysis have provided the evidence that due to the country specific factors, Azerbaijani banks have maintained low level of equity and higher debt. In actually, they have gained benefit from this condition and therefore they tend to hold more borrowing. Their leverage ratio also proves that even though the index is very high and risky, it cannot be serious problem for them. It is also important to note that, the main reason of previous failure banks is that, they could not meet minimum capital requirement in their authorized capital. Their equity actually was lower than minimum requirements because of losses on retained earnings and as we know retained earnings is a part of equity. For this reason, decreasing in retained

earnings causes to reduce in equity at the same time. Due to reducing retained earnings, failure banks equity have eroded year by year and consequently they could not meet minimum capital requirement. This evidence has shown that, keeping more equity is more safety and riskless. In contrast, preferring external source of finance like debt is the significant source of risk.

4. Conclusion and Implications

4.1 Conclusion and Summary

The decision of capital structure has been one of the most important issues for banks' activities for many years in Azerbaijan. Therefore, analyzing different factors which influence capital structure of banks have been considered as an essential research for current financial systems. The role of banks is significant in banking oriented countries such as Azerbaijan. Banks' activity is connected with all society and thus any problem in banks can affect to all society and economy as well. Banks need to make optimal decision in their capital structure in order to continue their activity. Capital structure decision and enhancement of operating are associated with each other in banks' activity. Making any wrong decision in capital structure can result in negative problems. This research has shown that, the decision of banks' capital structure depending on not only banks' internal choice but also external factors like country factors. Furthermore, the capital structure decision is affected by various macroeconomic, institutional, financial country characteristics. This research has proved that, the impact of country characteristic is significant for Azerbaijani banks by showing evidences. Especially double taxation principle which considers that corporate profit and dividend are taxable influence directly to bank's decisions. Due to tax code Azerbaijani banks have to pay 20% of profit tax and 10% of dividend tax. For this reason, banks prefer to keep more debt rather than equity. On the other hand, due to tax code interest payment can be deductable for computing total profit tax. This factor induces banks to take more borrowing because of its advantages. There are also agency costs between the board of directors of banks and major investors-shareholders. It occurs when managers' interest and shareholders objectives are not same and thus shareholders do not tend to invest more money. In sum, these evidences have demonstrated that the impact of country specific factors on capital structure of Azerbaijani banks is significant.

4.2 Contribution and recommendation

This study is also relevant to the recent financial crisis and discussion over prospective regulation of Azerbaijani banks. The failure of major Azerbaijani commercial banks beginning in the crisis has been in large amount of debt and they held very high financial leverage. This research can provide beneficial awareness concerning this problem. There are two recommendations in this paper and both of them mainly associated with the tax factors, because most evidences have shown that tax factor play leading role. First proposal consider the tax-exempt investors for dividend tax and according to second proposal dividend tax rate should be marginal not fixed.

Due to first recommendation, shareholders of banks may be unwilling to pay the dividend tax. This research suggests that some investors can be tax-exempt investors. This recommendation proposes that low level profitable banks should not pay dividend tax. If this suggestion is accepted by tax code, then some investors do not need to pay dividend tax from their annual dividend. For instance, when shareholders of any Azerbaijani bank have gained 100,000 manats or less from annual dividend, it is better for them not to pay dividend tax. Another good example of this is more profitable shareholders. For example, when shareholders of banks have received more than 500,000 manat from annual dividend, in this case they have to pay 10% of dividend tax. In actually, they should pay more than 10%, even 15% is appropriate rate. From these consequences, a new proposal is offered by this research.

According to the second recommendation, dividend tax rate should be marginal. It means that, lower profitable investors have to pay low dividend tax, such as 3%, 5% rates, and higher profitable investors have to pay high dividend tax, such as 15%, 20% rates. According to current Azerbaijan tax code dividend tax rate is 10%, in addition dividend tax is fixed for all investors. This condition is not known as an ideal condition. It is better to apply marginal dividend tax rates and this condition is

more appropriate and beneficial for investors. If this recommendation is accepted, it is possible that low level profitable banks can enhance their financial situation because low dividend rate results in spending low cash outflow. In sum, if Azerbaijan tax code is changed it will directly affect the dividend policy of bank.

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