



# The Effect of Funding Source on Profitability of BPR

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**Abstract.** Profitability plays an important role in ensuring that financial institutions can survive in the long term. This study focuses on funding sources and profitability by considering two variables that refer to profitability, namely Return on Assets and performance efficiency (BOPO) using the Balanced data panel from 34 BPR in Indonesia for the 2018–2021 period. Panel data regression analysis has been used in this research. EAR and DTL have a positive effect on ROA. Furthermore, EAR, DTL, LDR, and Size increase performance efficiency (BOPO). The findings will enable BPRs or other financial institutions to utilize resources to maximize financial performance that has an impact on profitability.

**Keywords:** Microfinance institutions · Funding sources · Profitability

## 1 Introduction

Statistics Indonesia, known in Indonesia as BPS (or Badan Pusat Statistik, the Central Bureau of Statistics) published in March 2022 that the percentage of poor people in Indonesia reached 9,54% or about 26,16 million people were plunged into poverty. As for poverty alleviation efforts and improvement of living conditions of the poor, the government is well placed to the initiative to provide access to financial services. However, the poor is considered as a bad risk by Banks, and they refuse to provide credit access to the poor (Sheremenko, et al., 2017) [1]. Unable to start or expand their micro-enterprises, it is incredible difficult for the poor to break out of their impoverished status.

Microfinance exists to fill the gap. Microfinance services in Indonesia, such as BRI village units (known as BRI unit Desa), are considered to have success in reducing poverty (Robinson, 2002) [2]. Microfinance aims to help the impoverished people, low-income households, or even micro-enterprises by providing financial services, including microcredit, that are accessible to them. Microfinance is an instrument of economic development that enables the poor to increase their productivity and income by providing more job opportunities.

To alleviate poverty effectively in the long term, apart from having a wide outreach, microfinance services must be profitable to sustain for long term. According to Parvin, et al. (2020) [3], microfinance faces two challenges: first, MFIs provide access to financial services for the poor, and second, microfinance needs to cover expenses.

MFIs need to gain profit to reduce their vulnerability to internal and external shocks. Therefore, MFIs aims to earn and maximize profits to cover its expenses and develop in long term at the same time (going concern principal). Profitability plays a critical role to predict such future conditions and become concerned about the possibility of bankruptcy risk. These can be understood as profitability of MFIs has some certain impacts on some decision makings of microfinance operation.

In some literature, profitability is defined in various ways. Parvin, et al. (2020) [3] referred profitability as financial goal, which is related to financial feasibility of MFIs and their capability to generate profits and how to run its business operations. Zobolotnyy and Wasilewski (2019) [4] defined profitability as the ability to generate value and provide operation continuity in long term by using an optimal combination of investments and financing sources. Meanwhile Munawir (2001) [5] mentioned that the higher the expected profit, then the better financial institution can sustain and develop competitively.

Bank Perkreditan Rakyat (also known as BPR, or Rural Bank) has been known as a kind of microfinance institution categorized as a Bank and carries out its activities by creating access to financial services to MSMEs and rural households. However, the number of BPRs in Indonesia is currently decreasing to around 1.646 BPRs since consolidations and mergers occurs more often in the last few years for capital strengthening. MFIs has to deal with such lack of capital since MFIs are considered to have a high risk due to high levels of asymmetric information (Fitriasari, T dan Dalimunthe, Z., 2019) [11]. Another reason is repayment behavior among microfinance clients. The poor may potentially have inability to repay loan since there is no income stability and asset that can be used as collateral. BPRs as a business entity that collects public funds and distributes them in form of loans with the aim of generating a profit, so credit is the only source of income from the spread effect and interest income. Therefore, microfinance institutions need strong financial support. Capital constraint causes MFIs to be very selective with their clients, thus requiring expansion of funding source (Bogan, 2012) [7].

Source of funding of BPR can be obtained from an internal or external source. Some empirical studies show that source of funds affects the profitability [3, 4, 12–14]. Unfortunately, there is no single, widely accepted and used relationship between source of funds and profitability. The aim of this study is to fill this gap. This study attempts to assess the effect of source of fund on profitability. The primary objective is to establish whether source of fund might affect negatively, or positively profitability of MFIs measured by BOPO as efficiency ratio and *Return on Assets* as profitability ratio. This study aims to answer this question.

## 2 Literature Review and Hypotheses Development

### *The Theoretical Framework of Source of Fund*

The significant theories of capital structure have been highlighted on several literatures: Trade-off theory, agency theory, and pecking order theory. Modigliani and Miller's (MM) (1958) [15] theorem stated that capital structure has no material effects on the firm value, assuming a perfect capital market. As a result of criticism of MM theorem, Trade-off theory arose which recognized the tax benefit of debt. Brigham, et al. (1999) [16]

explained that the concept of trade-off or balancing theory is about balancing the benefits and sacrifices that incurred because of use of debt. The trade-off theory predicts optimal leverage in which companies seek a balance between tax benefit of debt and bankruptcy risk. However, when capital structure of a firm implies debt financing, bankruptcy-related problems are most likely to occur. Myers (1984) [17] stated that the forces of moving leverage to an optimal level were overwhelmed by the cost of issuing risky debt or equity.

The pecking order theory then arises. Pecking order theory discusses the sequence of source of fund decisions. Pecking order theory starts with the concept of asymmetric information, also known as information failure, as managers know more about firm's prospect, risk, value than outside investors. The choice between internal and external financing is affected by asymmetric information. Firms finance their operations beginning with retained earnings, then progressing through safe debt, then with risky debt, and issuing equity for the last. Myers (1984) [17] suggested that more profitable firms require less need for debt or external financing since firms generate cash internally.

Moreover, agency theory addresses the problems of asymmetric information between the managers as agents and owner as principals. Jensen & Meckling (1976) [18] stated that the agency problem occurs due to a mismatch between goals of agents and the principal. Agents tend to maximize their own best profits at prior, instead of focusing to maximize the principals' welfare. To overcome the conflict of interest that might arise between agents and owner, agency costs are considered.

#### *Source of Fund Studies*

BPRs funding needs can be met by either borrowing from the bank which is consisting of loans received and immediate liabilities or collecting from customer consisting of deposits and saving, and the last, standing for own fund which is originated from the internal bank itself. To examine the relationship between source of fund and profitability of MFIs, the authors explored the existing literature. Several studies provided empirical evidence that source of fund affects profitability. Source of fund has a greater control over decisions regarding the profitability of microfinance institutions. Parvin, et al. (2020) [3] investigated a dataset of 187 MFIs in Bangladesh. Regression analysis had been used for this study to establish the relationship between source of fund and profitability. Considering Return on assets (ROA) and net income to expenditure ratio (NIER) as a proxy of profitability while debt to loan, deposit to loan, deposit to asset, and equity to asset as capital structure composition. They found debt financing had negative impact on the ability of MFIs to cover their expenses, but upsurged profitability. Several studies also provided empirical evidence that debt has positive effect on profitability [6, 13, 19–21]. In another study, Chauhan, et al. (2022) [12] have studied the relationship in the Indian context. The result was that debt financing has negative impact as expected in various studies [22–24].

Curak, et al. (2012) [25] explained loan to deposit ratio might describe how well liquidity of MFIs is and MFI's ability to disburse loans using third-party funds. The findings showed significant positive relationship between LDR and ROA. LDR is expected to be able to efficiently use operational costs.

Deposit is relevant for microfinance institutions that mobilize deposit. Deposit finance is cheaper than debt financing [19]. Higher deposit also is associated with improved profitability, assuming that the deposits mobilization programs is efficient.

Though, many MFIs used internal saving to solve liquidity problems, deposit indeed had a positive impact but not significant [3]. Abrar and Javaid (2016) [6] in their study considered operational self-sufficiency (OSS) and ROA as proxy of profitability and showed that deposits are the most cost-effective financial source. Moreover, García-Herrero, et al. (2009) [26] found no significant result between deposit to asset ratio and profitability.

Indayani and Ghozali (2017) [27] stated that internal funds are funding sources found within equity in form of share capital, reserves, previous and current year's profit. Parvin, et al. (2020) [3] found that equity has significant and positive impact on both return on assets and NIER and suggested equity-financing to finance operations. Several authors also provided empirical evidence that equity has an associate positively with profitability of MFIs [6, 19, 20]. Furthermore, top managers need to understand how they compose both equity and debt to reach positive outcome of MFIs.

Based on the previous discussion, in this section the following null hypothesis will be tested:

**Hypothesis 1 ( $H_1$ ):** There is relationship between debt to loan ratio and ROA and BOPO of MFIs.

**Hypothesis 2 ( $H_2$ ):** There is relationship between loan to deposit ratio and ROA and BOPO of MFIs.

**Hypothesis 3 ( $H_3$ ):** There is relationship between deposit to asset ratio and ROA and BOPO of MFIs.

**Hypothesis 4 ( $H_4$ ):** There is relationship between equity to asset ratio and ROA and BOPO of MFIs.

### 3 Data and Methodology

#### 3.1 Data

This research has used a balanced panel data of 34 BPRs in Indonesia, collected from quarterly financial statement published on the Financial Services Authority, known in Indonesia as Otoritas Jasa Keuangan (or OJK). This study contains dataset with a period of four years from 2018 to 2021 and is selected by purposive sampling method. In addition to the availability and completeness of the data, this study has used BPRs classified as category BPRKU3 or having a core capital of more than 50 billion with the assumption that since financial performance of the BPRs is good, profitability can be made.

Furthermore, BPRs are also selected based on ranking, which are rank 1 of the composite rating for assessing the health level of BPRs. Rank 1 explains that MFIs are in a very healthy condition and have strong ability to deal with changes in business conditions and other external factors, such as risk profile, implementation of good corporate governance, profitability, and an adequate capital.

In this study, for processing and analysis of data, STATA-17 has been used. The impact of source of funds on profitability has been assessed using regression analysis. Profitability of MFIs is proxied by Return on Assets and BOPO (or Operating expenses against Operating Income) as efficiency ratio to describe the ability of MFIs could cover its costs from its own generated income.

## 3.2 Specification of Variables

### 3.2.1 Dependent Variables

Return on Assets (or known as ROA) describes the ability of the microfinance institution uses its assets to generate profits. ROA is the most commonly used as profitability ratio in several studies [3, 6, 13, 19, 20, 24]. ROA is measured as follows:

$$\text{ROA} = \frac{\text{Net Income}}{\text{Total Assets}} \quad (1)$$

BOPO denotes the ability of MFIs to comprehensively cover all costs through operational and financial income. BOPO is a ratio that indicates the level of efficiency of MFIs. The smaller of BOPO ratio, the more efficient MFIs are in operating. BOPO is measured as follows:

$$\text{BOPO} = \frac{\text{Total Expenses}}{\text{Total Income}} \quad (2)$$

### 3.2.2 Independent Variables

In this study, the independent variables are:

Equity to Assets Ratio (EAR) measures the amount of total equity to its total assets. Several authors [3, 6, 27] uses this ratio to determine the contribution from total equity to fund MFIs operations. EAR is measured as:

$$\text{EAR} = \frac{\text{Total Equity}}{\text{Total Assets}} \quad (3)$$

Debt to Loan Ratio (or known as DTL) is a ratio to measure the amount of fund borrowed by the MFIs to its loan (Parvin, et al., 2020) [3]. The higher DTL indicates the higher use of debt. DTL is measured as:

$$\text{DTL} = \frac{\text{Debt}}{\text{Loan}} \quad (4)$$

Loan to Deposit Ratio (LDR) measures the volume of loans MFI must give out as a percentage of its total deposit. Loan to Deposit ratio is an inverse proxy for the liquidity (Curak, et al., 2012) [25]. The lower liquidity (means higher loan to deposit ratio) would imply higher profitability. LDR is measured as:

$$\text{LDR} = \frac{\text{Loan}}{\text{Deposit}} \quad (5)$$

Deposit to Asset Ratio (DAR) measures deposits contributed to its operation. Several authors [3, 6, 19] use this ratio to provide precise analysis of the role of deposits as a source of funds. DAR is measured as:

$$\text{DAR} = \frac{\text{Deposit}}{\text{Asset}} \quad (6)$$

### 3.2.3 Control Variables

In this study, control variable is needed, so it does not affect the independent and dependent variables. This research considered two control variables, considering firm's size and Non-Performing Loan (or NPL) as risk.

This study has included size since larger companies might have better access to capital market for long term and smaller firms may obtain short-term funding (Parvin, et al., 2020) [3]. Size has defined as the natural logarithm of total assets.

$$\text{Size} = \log (\text{Total Assets}) \quad (7)$$

Risk is considered as a measure that affects negatively on financial performance, profit, and efficiency. Non-performing loan (NPL) as a credit risk ratio would increase in line with the increase in lending. The higher NPL indicates that the credit risk borne by the BPR is also getting bigger. However, refers to the provisions of Bank Indonesia that healthy and good NPL is less than 5%. NPL is measured as follows:

$$\text{NPL} = \frac{\text{Total Non - Performing Loan}}{\text{Total Loan}} \quad (8)$$

#### *Empirical Model*

The study employs two panel regression model for measuring financial performance of MFIs:

$$\begin{aligned} \text{ROA}_{i,t} = & \alpha_0 + \beta_1 \text{EAR}_{i,t} + \beta_2 \text{DTL}_{i,t} + \beta_3 \text{LDR}_{i,t} \\ & + \beta_4 \text{DAR}_{i,t} \\ & + \beta_5 \text{Size}_{i,t} \\ & + \beta_6 \text{NPL}_{i,t} + \varepsilon_{i,t} \end{aligned} \quad (9)$$

$$\begin{aligned} \text{BOPO}_{i,t} = & \alpha_0 + \beta_1 \text{EAR}_{i,t} + \beta_2 \text{DTL}_{i,t} + \beta_3 \text{LDR}_{i,t} \\ & + \beta_4 \text{DAR}_{i,t} \\ & + \beta_5 \text{Size}_{i,t} \\ & + \beta_6 \text{NPL}_{i,t} + \varepsilon_{i,t} \end{aligned} \quad (10)$$

Equations (9), (10) presents dependent variable ROA and BOPO of MFIs  $i$  at a time  $t$ , while predictor or independent variables are EAR, DTL, LDR and DAR.

## 4 Results and Discussion

Table 1 presents the descriptive statistics of dependent, independent and control variables. Data shows that the standard deviation score of ROA is 0,03, with a mean value of 4,3%. It means that BPRs can provide a return on each capital of 0,04 times.

The mean value of BOPO was 74,83% which is in an ideal condition since refers to the provisions of Bank Indonesia, healthy and good BOPO is not more than 85%. For EAR, the sample MFIs have mean values of 17,9%. The mean value of DTL is 13,7%,

**Table 1.** Descriptive Statistics

Variable	Obs	Mean	Std. dev.	Min	Max
ROA	544	0,0434428	0,0386662	-0,0204	0,5
BOPO	544	0,7483532	0,0910804	0,4157	1,2033
EAR	544	0,1791083	0,12283	0,083056	0,7654195
DTL	544	0,1374844	0,1794262	0,0006957	0,7010832
LDR	544	0,8128921	0,1139251	0,0349	1,073
DAR	544	0,8844697	3,48314	0,1976108	59,13142
SIZE	544	11,7703	0,3667413	10,52876	12,99727
NPL	544	0,0262384	0,0351162	0,000792	0,66

Source: The author computation by using Stata-17

Note: This table shows descriptive statistics of all the variables used in this study

while LDR has mean value of 81,29%. The value is above the minimum LDR according to provisions of Bank Indonesia, which is 78%. Another independent variable, DAR, has an average value of 0,884.

Table 2 presents the correlation matrix. Correlation matrix can be used to identify whether correlation exists as results of the relationship between sets of independent variables. It is expected that there is no correlation between explanatory variables.

The highest correlation analysis result is the relationship between ROA and BOPO variables of -0,5449, It has a negative correlation coefficient which describes the extent to which two variables move in opposite directions. An increase in BOPO is associated with a decrease in ROA. The highest positive correlation coefficient between size and DTL is 0,5093. A positive correlation indicates that the variables move in the same direction. As size increases, so too do DTL.

**Table 2.** Correlation Matrix

	ROA	BOPO	EAR	DTL	LDR	DAR	Size	NPL
ROA	1,0000							
BOPO	-0,5449	1,0000						
EAR	0,2229	-0,4461	1,0000					
DTL	-0,0910	0,1760	-0,2635	1,0000				
LDR	-0,0166	-0,0323	-0,3293	0,2058	1,0000			
DAR	-0,0146	-0,0064	0,0006	-0,0420	0,0390	1,0000		
SIZE	-0,2442	0,0334	-0,3279	0,5093	0,1544	0,0640	1,0000	
NPL	-0,0103	0,0798	0,1606	-0,1327	-0,2344	-0,0147	-0,2003	1,0000

Source: The author computation by using Stata-17

**Table 3.** Panel Regression Results

<b>Regresi model dengan robustness</b>				
<b>Variable Dependent: Return on Assets (ROA)</b>			<b>Variable Dependent: BOPO</b>	
<b>Variable</b>	<b>Random</b>	<b>Robust</b>	<b>Fixed</b>	<b>Robust</b>
EAR	0,04686559	0,04686559	-0,15981362	-0,15981362
DTL	0,02050685	0,02050685	-0,1811133	-0,1811133
LDR	-0,00668082	-0,00668082	-0,1578857***	-0,15788575*
DAR	-0,00007368	-0,0000736**	0,00054614	0,0005461***
Size	-0,036265***	-0,03626519*	-0,01120094	-0,01120094
NPL	-0,02500941	-0,02500941	0,08023926	0,08023926

Source: The author computation by using Stata-17

Note: All regression includes a constant, number of observations, and Hausman test value. The coefficient value is given. \* Significant at 5%, \*\* significant at 1%, and \*\*\* significant at 0,1%

### **Source of Funds and Profitability**

Table 3 reports the regression results, presenting the relationship of different source of fund on ROA and BOPO. As per regression results, DTL has positive but not significant impact on ROA, while DTL has negative but not significant impact on BOPO. Positive relation with ROA is because the higher the loan disbursed, the higher return on credit interest earned, assuming no bad credit occurs. In the perspective of trade-off theory, debt financing provides profits to firms because of interest and dividend payments. Interest payments are considered as expense and tax income will be reduced. A negative value of BOPO indicates that firms are more efficient since debt financing forces companies to adopt more efficient by trimming down and preventing the unnecessary expenses.

LDR has a negative but not significant impact on ROA, while has a positive and significant impact on BOPO. It means that LDR ratio increase causes a decrease in profit and tends to be inefficient. Disbursing loan without adhering to the principle of prudence, MFIs that experience failure are due to the liquidity issues. Regression results also show that there is negative and significant relationship between DAR and ROA, while positive and significant relationship with BOPO. An increase of DAR ratio tends to reduce profitability and increase BOPO, which tends to be inefficient. Whereas deposits are the largest source of funds of BPRs. Deposits have a higher interest percentage. An increase of deposits will certainly increase the percentage of interest that must be provided by BPRs. It causes a reduction in BPR interest margins. Therefore, the LDR ratio must be maintained by Banks, not exceed the maximum limit following the provisions by Bank Indonesia. EAR has a positive but not significant impact on ROA, and a negative but not significant impact on BOPO It means that EAR increases profitability and makes firms more efficient. The result is in line with pecking order theory, internal funding is preferred by companies. Since firms use internal financing to finance its operations, principal tends to be aggressive in taking a role when making decisions for improving performance or increasing efficiency to obtain maximum profitability.



Size has significant and negative impact on ROA and BOPO. The larger size of company, it tends to be efficient. Large-sized MFIs could maximize the available resources so that the costs of collecting and processing the required information can be more economical than small-sized MFIs. Furthermore, NPL has negative but not significant on ROA, and positive but not significant on BOPO. Disbursing loans contains credit risk which will affect negatively on the continuity of BPRs.

## 5 Conclusion

Capital structure decisions play an important role for any business organization. This study attempts to examine how source of funding affects profitability which refers to profitability and operation efficiency. From the various previous literature, overall empirical evidence remains debatable. Since contradictory results exist, it becomes clear that the relationship between source of fund and profitability is relatively worthy of being the focus of research. Therefore, this study not only contributes to further understanding the relationship, but also expands on previous studies.

This study uses random and fixed effect models to do analysis panel data of 34 BPRs in Indonesia. The results show that EAR and DTL have a positive effect on profitability proxied by ROA. Furthermore, EAR, DTL, LDR, and Size affect BPRs' performance to be efficient proxied by BOPO. These findings contribute to the growing body of evidence on and better understanding of correlation between source of fund and profitability. These findings also supplement existing knowledge for policy maker with greater attention to the development and implementation of a balanced source of fund of MFIs or other financial institutions in Indonesia to reach out profitability. To remain sustainable and operational over the long term, it is very important for BPRs or other financial institutions to remain profitable.

### *Limitations and Future Research*

This study considered only Indonesian MFIs to be investigated, which are 34 BPRs in the 2018–2021 period. The results of this study are applicable only in Indonesian context. Future research could use more BPRs and longer period to provide the research results richer. Furthermore, this study only considers two dependent variables, four independent variables, and two control variables to examine the impact of source of fund on profitability. Several independent variables can be affected by the dependent variable of regression model and it might cause endogeneity problem. Unfortunately, this study does not examine the endogeneity problems. Further research might be recommended to also analyse the impact of funding source on both the financial and social performance of microfinance institutions.

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