

## THE DYNAMIC IMPACT OF LEVERAGE RISK AND CAPITAL STRUCTURE ON THE MARKET CAP OF COMMERCIAL BANKS: A STANDARD ANALYSIS USING THE (ARDL) MODEL OF A SAMPLE OF IRAQI BANKS

### *O IMPACTO DINÂMICO DO RISCO DE ALAVANCAGEM E DA ESTRUTURA DE CAPITAL NA CAPITALIZAÇÃO DE MERCADO DOS BANCOS COMERCIAIS: UMA ANÁLISE PADRÃO UTILIZANDO O MODELO ARDL EM UMA AMOSTRA DE BANCOS IRAQUIANOS*

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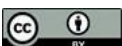
#### **Abstract**

This study aims to analyze the dynamic impact of leverage risk and capital structure on the market capitalization of a sample of Iraqi commercial banks listed on the Iraq Stock Exchange over the period 2004–2024, using annual time-series data. The Autoregressive Distributed Lag (ARDL) model was employed after testing the stationarity of the study variables using the Phillips–Perron test. The results of the bounds test indicate the existence of a long-run equilibrium relationship among the study variables. Furthermore, the ARDL model explains approximately 97% of the variations in market capitalization. The findings reveal that some leverage indicators have a statistically significant negative effect on market capitalization, while the impact of capital structure appears weak and varies in terms of statistical significance. Additionally, the regression results suggest that financing variables explain only a limited proportion of fluctuations in market value despite their statistical significance, reflecting the influence of other market and financial factors on stock pricing. This study provides empirical evidence from the Iraqi banking sector on the dynamic relationship between leverage, capital structure, and market capitalization within an emerging financial environment.

**Keywords:** Leverage. Capital Structure. Market Cap. Model (ARDL).

#### **Resumo**

*Este estudo tem como objetivo analisar o impacto dinâmico do risco de alavancagem e da estrutura de capital sobre a capitalização de mercado de uma amostra de bancos comerciais iraquianos listados na Bolsa de Valores do Iraque no período de 2004 a 2024, utilizando dados de séries temporais anuais. O modelo ARDL (Autoregressive Distributed Lag) foi empregado após o teste de estacionariedade das variáveis do estudo, realizado por meio do teste de Phillips-Perron. Os resultados do teste de limites indicam a existência de uma relação de equilíbrio de longo prazo entre as variáveis do estudo. Além disso, o modelo ARDL explica aproximadamente 97% das variações na capitalização de mercado. Os resultados revelam que alguns indicadores de alavancagem têm um efeito negativo estatisticamente significativo sobre a capitalização de mercado, enquanto o impacto da estrutura de capital parece fraco e varia em termos de significância estatística. Além disso, os resultados da regressão sugerem que as variáveis de financiamento explicam apenas uma proporção limitada das flutuações no valor de mercado, apesar de sua significância estatística, refletindo a influência de outros fatores de mercado e financeiros na precificação das ações. Este estudo fornece evidências empíricas do setor bancário iraquiano sobre a relação dinâmica entre alavancagem, estrutura de capital e capitalização de mercado dentro de um ambiente financeiro emergente.*



*Palavras-chave:* Alavancagem. Estrutura de Capital. Capitalização de Mercado. Modelo ARDL.

## 1 INTRODUCTION

Leverage risk management decisions and capital structure play a pivotal role in determining the market value of banking institutions because of their direct impact on the level of risk, returns, and investor confidence (Myers, 1984; Titman & Wessels, 1988).

Choosing the optimal mix among external and internal sources of financing is one of the most important strategic decisions facing bank management, and this is reflected in its ability in terms of achieving financial stability and increasing the value of shares in the market (Modigliani & Millre, 1958).

The financial literature has witnessed an increasing importance in studying the relationship between leverage, capital structure and market capitalization, in light of the disparity in the results of previous studies between those who emphasize the positive role of leverage in maximizing the value of the enterprise by benefiting from the tax and those who believe that high levels of indebtedness increase financial risks and lead to a decrease in the market valuation of institutions (Myers & Majluf, 1984; Jensen & Meckling, 1976).

Despite the multiplicity of applied studies in developed environments, standard evidence in emerging markets is still limited, especially those that rely on dynamic models that take into account the nature of time series and the interaction of financing variables with market value over time (Rajan & Zingales, 1995) and (Weinstein & Yafeh, 1998).

Based on this, this research aims to analyze the dynamic impact of leverage risks and capital structure on the market capitalization of the shares of a sample of Iraqi commercial banks listed on the Iraq Stock Exchange during the period from 2004 to 2024 based on annual time series data and the application of the (ARDL) model.

## 2 LITERATURE REVIEW

Financial literature is concerned with explaining the relationship. Between leverage and capital structure on the one hand and market capitalization or stock returns on the other hand, but the applied results differ according to the different economic environments and sectors used in the analysis (Beasley et al., 2008). (Al-Najjar, 2013, p. 287).

Some studies have indicated that higher levels of leverage may contribute to maximizing the value of stocks by taking advantage of the advantages of debt financing, while other studies confirm that increased reliance on indebtedness is associated with higher financial risks and lower market valuation of stocks, especially in emerging markets characterized by information instability and volatility of the economic environment (Milley, 2013, p. 11).

A number of studies have also addressed the capital structure, as it has been described as a key determinant in the valuation of companies in the financial market, as achieving an appropriate balance between debt and equity may enhance the market value, while the misallocation of funding sources may lead to a decrease in investor confidence and the fluctuation of stock prices (Ripamonti, 2020) (Gangeni, 2006).

The applied literature shows that the nature of the relationship between leverage, capital structure, and market capitalization varies according to the sector, and this affects banking institutions with its regulatory restrictions and solvency indicators that differ from non-financial sectors, which makes the results of studies often heterogeneous (Kapoor, 2009:134) (Linge, 2015) (Paiti & Syufaat, 2021) (Peavler, 2011:13).

Despite the multitude of Arab and foreign studies that have dealt with this relationship, most of them have focused on advanced economic environments or non-banking sectors, while applied studies that address the dynamic impact of leverage risks and capital structure on market capitalization in the Iraqi banking sector are still limited, so the current study seeks to bridge this gap by analyzing the relationship between leverage risks, capital structure and market capitalization of the shares of two Iraqi commercial banks using the ARDL model.) and time series data from 2004 to 2024 which provides an applied guide that enhances the understanding of the nature of this relationship in an emerging banking environment.

### **3 RESEARCH HYPOTHESES**

Based on the problem of the study and its objectives, the following main hypotheses were formulated:

#### **3.1 Correlation hypotheses**

H1: There is a statistically significant relationship between leverage indicators and the market value of the stocks of the banks in the study sample.

H2: There is a statistically significant relationship between leverage indicators and capital structure in the study sample banks.

H3: There is a statistically significant relationship between the capital structure indicators and the market value of the shares of the banks in the study sample.

#### **3.2 Impact hypotheses**

H4: There is a statistically significant effect of leverage indicators on the market value of the banks' stocks in the study sample.

H5: There is a statistically significant effect of capital structure indicators on the market value of the shares of the banks in the study sample.

### **4 METHODOLOGY**

#### **4.1 Research design**

This study adopts the standard analytical approach to analyze the relationship between leverage risk, capital structure, and market capitalization of the stocks of the banks in the study sample, through the use of annual time series data and testing the short- and long-term relationships between the study variables.

## 4.2 Data and sample

The study is based on secondary data obtained from the annual financial reports of banks listed on the Iraq Stock Exchange. The sample of the study is two Iraqi commercial banks, which were selected to represent the banking sector during the period from 2004 to 2024, ensuring the availability of sequential data that allows for standardized analysis and hypothesis testing.

## 4.3 Study variables

### 4.3.1 Independent variables

The independent variables were the leverage risk indicators and the components of the capital structure, which were measured using a set of financial ratios, the most important of which are:

- Total debt to total assets ratio.
- Debt to equity ratio.
- Debt-to-capital financing ratio.
- Ratio of capital to funding structure
- Retained Profit Percentage

### 4.3.2 Dependent variable

It was represented in the market value of the banks' shares, which was measured by:

- Market Value of Shares
- Trading Volume
- Market Value of Traded Shares

## 5 ECONOMETRIC TECHNIQUES

To achieve the objectives of the study and test its hypotheses, a set of statistical and standard tools was used, namely:

1. Test the stability of time series using the Phillips–Perron test.
2. Testing the presence of co-integration between variables using the Bounds test.
3. Estimation of the Distributed Lag Self-Regression Model (ARDL) to measure the short- and long-run relationship between variables.
4. Analysis of correlation coefficients to determine the nature of the relationship between independent and dependent variables.

## 6 MODEL SPECIFICATION

The ARDL model was adopted to measure the impact of leverage indicators and capital structure on the market value of the shares of the banks in the study sample, because it is suitable for the data of time series, which vary in their degree of stability between the level and the first difference.

### 6.1 Results and Discussion

#### 6.1.1 Unit root Test Results

The time series stability of the study variables was tested using the Phillips–Perron test, and the results showed that some variables were stable at the level, while others became stable after taking the first difference, indicating the integration of the zero and first order variables. Therefore, the ARDL model is suitable for analyzing the relationship between variables.

#### 6.1.2 Bounds test for cointegration

The results of the boundary test showed that there is a long-term equilibrium relationship between leverage indicators, capital structure, and market value of the banks'

shares in the study sample, where the calculated value (F) exceeded the tabular values at different significant levels, which confirms the existence of a common integration between the variables.

### *6.1.3 ARDL model estimation*

The results of estimating the ARDL model showed that the independent variables explain a high percentage of the changes in the market value of banks' shares, as the determination coefficient reached about (97%), which indicates the strength of the model in interpreting the relationship between the study variables.

The results also showed that there is a significant impact of some leverage indicators on the market capitalization in a negative direction, indicating that high levels of indebtedness may lead to a decrease in the market valuation of banks' stocks as a result of increased financial risks.

On the other hand, the impact of the capital structure appeared to varying degrees in terms of statistical strength, as not all of its indicators were significant, reflecting the different response of the market value to the different components of finance.

### *6.1.4 Correlation analysis*

The results of the correlation analysis showed that there was a moderate positive relationship between leverage and market capitalization of (0.24), while a strong inverse relationship between leverage and capital structure was (-0.85), and a weak inverse relationship between capital structure and market capitalization was (-0.15).

### *6.1.5 Regression analysis*

The results of the regression models indicate that financing variables explain a limited percentage of market value fluctuations despite their statistical significance, which shows that stock pricing is not only dependent on financing indicators, but is also influenced by other market and economic factors such as investor expectations, liquidity level, and general economic conditions.

## 7 DISCUSSION

The results reflect the dynamic nature of the relationship between leverage risk, capital structure and market capitalization, where investors' valuation of banks is influenced by the level of risk associated with debt and the approved financing structure. These findings are consistent with a number of previous studies that have suggested that higher leverage may lead to increased risk and therefore lower market capitalization, while achieving an appropriate balance in the capital structure contributes to supporting the stability of equity prices.

The results also confirm that market capitalization is not only determined by financing decisions, but is also affected by other factors related to the market environment, information efficiency, and investor expectations, which explains the limited explanatory power of some financing variables.

### Model Specification and Variables

#### 7.1 Study variables

The study relies on a set of financial variables to measure the impact of leverage risks and capital structure on the market value of the banks' stocks in the study sample.

#### 7.2 Independent variables

##### 7.2.1 Leverage risk indicators

- Equity Multiplier Ratio (EMRI)
- Debt.-to-Assets Ratio (DTAR)
- Debt.-to-Equity Ratio (DTER)

##### 7.2.2 Capital structure indicators

- Debt-to-Capital Structure Ratio (DTCSR)

- Equity-to-Equity Structure Ratio (ETESR)
- Retained Earnings-to-Equity Ratio (RETER)
- Reserves-to-Capital Structure Ratio (RTCSR)
- Dependent Variable
- Market Value of Bank Shares (MV)

### 7.3 Econometric model

To analyze the relationship between leverage indicators, capital structure, and market capitalization of bank stocks, a standard regression model with a logarithmic formula was adopted, as follows:

#### 7.3.1 Model (1): Iraqi Islamic Bank for investment and development

$$\text{Log(MV)} = \beta_0 + \beta_1 \text{EMRI} + \beta_2 \text{DTAR} + \beta_3 \text{DTER} + \beta_4 \text{DTCSR} + \beta_5 \text{ETESR} + \beta_6 \text{RETER} + \beta_7 \text{RTCSR} + \varepsilon_t \quad (1)$$

#### 7.3.2 Model (2): National Bank of Iraq

$$\text{Log(MV)} = \beta_0 + \beta_1 \text{EMRI} + \beta_2 \text{DTAR} + \beta_3 \text{DTER} + \beta_4 \text{DTCSR} + \beta_5 \text{ETESR} + \beta_6 \text{RETER} + \beta_7 \text{RTCSR} + \varepsilon_t \quad (2)$$

It represents:

- $\text{Log(MV)}$ : The natural logarithm of the market capitalization of the bank's shares
- $\beta_0$ : Fixed limit
- $\beta_1$ – $\beta_7$ : coefficients of independent variables
- $\varepsilon_t$ : Random error limit

The ARDL model was chosen for its suitability to the nature of time series data whose degree of stability varies between the level and the first difference, and because of its ability to estimate short- and long-term relationships between variables.

Unit root test for independent and bank variables Study sample

UNIT ROOT TEST RESULTS TABL (PP)

NULL Hypothesis: the varabile has a unit root

**Table 1**

Variables	Rank	Integration
(MV/BB)		I(1)
RTCSR		I(0).
.RETER		I(1).
ETESR		I(1).
.DTCSR		I(1).
DTERR.		I(0).
DTARN.		I(0).
EMRI N		I(1)
(MV/BB)		I(1)
RTCSR I		I(0)
RETER I		I(1)
ETESR I		I(0)
DTCSR I		I(1)
DTERR I		I(1)
DTAR I.		I(0)
EMRI I.		I(1)

The results.of the Phillips–Perron test indicate that the study variables are complementary from different scores, as some variables stabilized at level I(0), while other variables became stable after taking the first difference I(1). This variation in integration scores confirms the appropriateness of using the Distributed Slowdown Self-Regression (ARDL) model to analyze the relationship between study variables, given its ability to deal with mixed time series in terms of degree of stability.

### 7.3.3 Bounds test for cointegration

The results of the boundary test showed that the calculated (F-statistic) value was (8.05), which is higher than the tabular values at significant levels (1%, 5%, 2.5%, and 10%), which indicates that there is a long-term equilibrium relationship between the study variables.

This result confirms the existence of a common integration between the leverage risk indicators, the capital structure and the market capitalization of the stocks of the sample banks, which justifies the use of the ARDL model to estimate the short- and long-term relationships between variables.

### 7.3.4 ARDL estimation results – Iraqi Islamic Bank

The results of the estimation of the ARDL model indicate a high explanatory power of the model in analyzing the relationship between leverage indicators, capital structure, and market capitalization of the shares of the Iraqi Islamic Bank for Investment and Development, where the determination coefficient ( $R^2$ ) reached about (0.978) and the adjusted determination coefficient (Adjusted  $R^2$ ) was about (0.974), demonstrating the ability of independent variables to account for a large proportion of changes in the market value of stocks.

The statistical value (F-statistic) was about (73.01), which reflects the morale of the model as a whole at high levels of significance. The Durbin–Watson coefficient of (2.52) indicates that there is no self-correlation problem between the residuals of the model, which enhances the reliability of the standard estimation results.

These results reflect the suitability of the ARDL model to analyze the relationship between the study variables and explain the changes in the market value of the bank's shares during the study period.

**Table 2**

R-squared	0.978397	Mean .dependent var	5.3288
Adjusted R-squared	0.97486	S.D. . dependent var	0.581729
S.E. of regression	0.092236	Akaike info. criterion	-1.62875
Sum. squared resid	0.10209	Schwarz. criterion	-0.90884
Log. likelihood	36.98808	Hannan.-Quinn criter.	-1.41468
F-statistic	73.01551	Durbin.-Watson stat	2.524112

### 7.3.5 ARDL estimation results – National Bank of Iraq

The results of the estimation of the ARDL model of the National Bank of Iraq indicate a high explanatory power of the model, where the determination coefficient ( $R^2$ ) reached about (0.987) and the adjusted coefficient of determination (adjusted  $R^2$ ) was about (0.976), which indicates that the independent variables explain a large percentage of the changes in the market value of the bank's shares.

The statistical value (F-statistic) reached about (80.31), which reflects the significance of the standard model at high significant levels. The Durbin–Watson

coefficient of (2.77) indicates that there is no self-correlation problem between the residuals of the model, which enhances the reliability of the standard results.

These results confirm the relevance of the ARDL model to analyze the relationship between leverage indicators, capital structure, and market capitalization of NCB shares during the study period.

**Table 3**

R-.squared	0.987568	Mean. dependent. var	5.86168
Adjusted. R-squared	0.97651	S.D. dependent. var	0.591867
S.E. of. regression	0.0934652	Akaike info .criterion	-1.63564
Sum .squared resid	0.10209	Schwarz .criterion	-0.91243
Log .likelihood	40.686888	Hannan-.Quinn criter.	-1.55615
F-.statistic	80.317061	Durbin-.Watson stat	2.776523

#### 7.4 Short-run dynamics – Iraqi Islamic Bank

The results of the ARDL model indicate that there are short-term effects of leverage indicators and capital structure on the market capitalization of Iraqi Islamic Bank shares. The total debt to capital index (DTER) has had a negative impact at the current level, while some variables have had significant effects at different slowdowns, notably:

- DTAR(-2) with a positive and significant effect
- DTCSR(-1) with a negative and significant impact
- Some ETESR, RETER and RECSR slowdowns at different levels of significance

These results suggest that the market capitalization response to changes in the financing structure is not immediate, but rather extends over time depending on the nature of the financing mix and the level of financial risk.

#### 7.5 Long-run relationship

Based on the results of the boundary test and the evidence of co-integration, it can be inferred that there is a long-term relationship between leverage indicators, capital structure and market capitalization of the bank's shares. Variable coefficients show that in the long run, higher levels of leverage are associated with a decline in market

capitalization as a result of increased financing risks, while the impact of capital structure components is seen to varying degrees depending on the nature of each indicator.

### **7.6 Error correction mechanism (ECM)**

The results of the model indicate that there is an error correction mechanism that rebalances the variables in the long run, as the slowdown coefficient of the market value was high and statistically significant, which indicates how quickly the system responds to changes in independent variables and returns to the long-term equilibrium path after any short-term shock.

This result reflects the dynamic nature of the relationship between funding decisions and market capitalization, as deviations from equilibrium are gradually corrected over time.

### **7.7 Model adequacy**

The coefficient of determination ( $R^2$ ) was about (0.988), which indicates a high explanatory power of the model, while the statistical value of (F) was about (73.01) at a high level of significance, which confirms the significance of the model as a whole. The Durban-Watson coefficient (2.52) also indicates that there is no self-binding problem between the residues of the model.

### **7.8 Short-run dynamics – National Bank of Iraq**

The results of the NBI's ARDL model indicate that there are short-term effects of leverage indicators and capital structure on the market capitalization of the bank's shares. The Equity Multiplier Index (EMRI) has had a significant impact at the current level and during the slowdowns, as well as the Debt to Total Assets Index (DTAR) and the Debt to Capital Index (DTER) at the current level and some of the slowdowns.

The results also showed a positive and significant impact of the Debt to Capital Structure Financing Index (DTCSR) at the current level, while a negative effect was seen

at the first slowdown period, reflecting the variation in the market capitalization response to changes in the components of the financing structure over time.

The coefficients of some of the slowdowns of the capital structure indices (ETESR, RETER, and RECSR) indicate that there are varying dynamic effects on market capitalization, reflecting the nonlinear nature of the relationship between financing variables and stock price behavior.

### **7.9 Long-run relationship**

Based on the results of the boundary test and the evidence of co-integration, it is clear that there is a long-term equilibrium relationship between leverage indicators, capital structure and market capitalization of NCB shares. Variables indicate that higher levels of indebtedness are associated with a decline in market capitalization in the long term as a result of increased financial risks, while the impact of some components of the capital structure is seen to varying degrees depending on the nature of each indicator.

### **7.10 Error correction mechanism (ECM)**

The results of the model indicate that there is an error correction mechanism that rebalances variables in the long run, where the slowdown coefficients reflect the system's response to changes in independent variables and the gradual return to equilibrium after short-term shocks.

### **7.11 Model adequacy**

The coefficient of determination ( $R^2$ ) was about (0.987), which indicates a high explanatory ability of the model, and the statistical value of (F) was about (80.31) at a high level of significance, which confirms the significance of the standard model as a whole. The Durbin–Watson coefficient (2.77) indicates that there is no self-correlation problem between the residuals of the model, which enhances the reliability of the standard results.

## 8 DISCUSSION

The results of the benchmark analysis indicate that there is a dynamic relationship between leverage risk, capital structure, and market capitalization of the banks' stocks in the study sample, as ARDL models showed that changes in leverage indicators directly affect the market valuation of bank stocks, especially in the short term, while the impact of the capital structure appears to varying degrees depending on the nature of its components.

It has been found that in many cases, high levels of indebtedness are associated with a decline in the market value of equities, which can be explained by higher financial risks and increased probabilities of default, which reflects negatively on investors' confidence and their assessment of banks' performance. This finding is consistent with the theoretical trend that the overuse of debt leads to an increase in the cost of capital and a decrease in the value of the enterprise.

In contrast, some capital structure indicators have shown unstable or uneven effects, reflecting that market capitalization is not only determined by funding decisions, but is also influenced by other factors such as market conditions, information efficiency, investor expectations, and the level of liquidity in the financial market.

The results also revealed that there is a long-term relationship between the variables, which indicates that the impact of financing decisions is not limited to the short term, but extends to affect the market value of banks over time, which reinforces the importance of balanced management of the capital structure in banking institutions.

These findings are consistent with a number of previous studies that have indicated that the relationship between leverage and market capitalization is not fixed, but is influenced by the nature of the sector, the economic environment, and the level of financial risk. The findings also support the theory that achieving an appropriate balance between internal and external sources of financing contributes to enhancing the stability of stock prices and maximizing the value of banks in the financial market.

The results also indicate that the explanatory effect of finance indices on market capitalization, while statistically significant, remains relatively limited compared to other market factors, reflecting the complex nature of equity price behavior in emerging markets, including Iraq.

## 9 CONCLUSIONS

The study found that there is a dynamic relationship between leverage risk, capital structure, and market capitalization of the banks' stocks in the study sample, as the results of the ARDL models showed that leverage indicators represent an influential factor in explaining changes in the market value of stocks, whether in the short or long term.

The results also showed that in many cases, high levels of indebtedness are associated with a decrease in market value as a result of increased financial risks, while the impact of the components of the capital structure appeared to varying degrees depending on the nature of each indicator, reflecting the different market response to the financing decisions adopted by banks.

The results of the boundary test showed that there is a long-term equilibrium relationship between the variables, which confirms that financing decisions do not have short-term effects, but extend to affect the market value of banks over time, which reinforces the importance of good management of the capital structure.

The results also revealed that financing variables, despite their statistical significance, do not account for all changes in market capitalization, as stock prices are also affected by other market and economic factors such as investor expectations, the level of liquidity, and the efficiency of information in the financial market.

This study contributes to providing a standard guide from the Iraqi banking environment that illustrates the nature of the relationship between leverage, capital structure, and market capitalization of equities, which represents an applied addition to the financial literature in emerging markets.

## 10 RECOMMENDATIONS

Based on the results of the benchmark analysis and the impact of leverage indicators and capital structure on the market capitalization of bank equities, the study recommends the following:

1. The need to adopt balanced financing policies that reduce over-reliance on debt, as this has a direct impact on reducing financial risks and improving the market valuation of bank equities.
2. Enhancing the efficiency of capital structure management by achieving an appropriate balance between internal and external sources of funding, which contributes to supporting financial stability and maximizing market capitalization.
3. Pay attention to financial risk indicators when making financing decisions, and not rely on indebtedness as a tool to maximize short-term profits at the expense of long-term stability.
4. Supporting investment decisions in banks based on the analysis of financing indicators and capital structure, as they play a role in interpreting the trends in the market value of shares.
5. Encouraging regulators to enhance financial disclosure levels in the banking sector, in a way that contributes to improving market efficiency and reducing information asymmetry.
6. Directing future studies to introduce other market and economic variables, such as liquidity, inflation, and economic growth, because of their potential role in explaining the behavior of the market value of banks' shares.

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**Authors' Contribution**

All authors contributed equally to the development of this article.

**Data availability**

All datasets relevant to this study's findings are fully available within the article.

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