
LEVERAGE AND LACK OF CONTROLLING AS SYMPTOMS OF THE FINANCIAL CRISES

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Abstract: Leverage is always tricky to address in the modern world.. There are several ways any company can leverage up the balance sheet in order to approach more financing to its activities. In the good economic times of economic growth and opening up of new markets it is easy to see the benefits. But in the times of tight financing opportunities there are a lot of problems to finance day to day operations. Leverage in that economic conditions is not a great tool to maximize value, but a great adversary.

Leverage has two disadvantages in tough economic times:

-It dries up the balance sheet

-There are a lot of payments towards interest

With this disadvantage the companies are required to divest assets at unattractive prices. That's how the global financial crisis began. Lack of control in the investment banking world and the diminished capacity to make decisions resulted in high leverage and unsustainable debt. What many economists didn't see was the pumping of the balloon. When the financing options dried up, global investment banks were required to sell assets to pay back their debt. This meant a lot of assets on the market that can only take a few of them. With this economic paradigm the results are always the same. Deep economic crisis, painful deleveraging and a lot of bankruptcies.

Keywords: leverage, control, financing

1. INTRODUCTION

Debt management is the best way to control the risks that companies are exposed to. By controlling the risks, companies can provide ways to survive on the markets, but at the same time and how to grow using their own capital in most cases with minimal debt. It is not necessary in the process of expansion that many foreign sources of funds are used so that in times of recession, the survival of the company can not be questioned.

2. EXPLANATION OF THE DESTRUCTIVITY OF THE LEVERAGE CONCEPT AT THE REMAINED ECONOMIC ACTIVITY

Most companies have problems financing their expansive policies primarily due to increased competition in markets and their sophistication. For this reason, they often decide to use leverage. But many choose to make it at a less responsive level, which in the end results in negative results.

According to the official calculations of many research agencies, leverage in normal transactions can usually be borrowed on average 19 times from its initial amount. To take an example of a person who has \$ 40,000 to invest and decide to use a leverage for investment.

If that person owns \$ 40,000 to invest using leverage, he can invest up to \$ 760,000 in a particular investment, using foreign assets of \$ 720,000. With a growth of only 10% and an increase of \$ 760,000 to \$ 836,000, gross profits is 76,000. Even with paying interest and taxes, net profit still represents over 120% growth from the initial investment.

Because of this, the leverage is quite intriguing for the companies, especially for the financial companies. As we can always calculate, the financial companies have large assets supported by much lower capital. Investment banks especially feel this because they are encouraged to borrow by borrowed funds in this way, which creates great pressure in times of reduced economic activity and recession.

It is therefore crucial to understand that economic activity and leverage must be reduced to rational levels. Most of the investment banks, construction companies, companies that sell building materials, citizens, etc., have seen quite destructive concepts of over-indebtedness. The global economic crisis occurred precisely because of this increased economic activity through excessive use of leverage that allowed to encourage the creation of the bubble in the real estate sector.

Leverage, unlike other types of debt strategies, is quite destructive primarily because of borrowing large amounts of money on relatively small collateral, which allows the so-called marginal trading. By utilizing these instruments, the financial company or the person who lends money shares the results that the person who is borrowing because the options are or the person to add new assets as collateral in order not to be liquidated

position or position must be liquidated which can be the loss of the person who lends, and, unfortunately, to the borrower.

This is precisely the epitomize of the economic crisis that began with the heavy borrowing of financial companies, which were indebted to their clients and other banks. This caused a "heating up" of the economic activity that led to major problems for the financial system.

Economic cycles are natural business in the markets, but there are often artificial inflows to markets that eventually result in negative financial consequences. The leverage concept has contributed enormously to this in the latest financial crisis, as according to official data of the Federal Reserve of the United States, the rate of trading the margin grew by 300% from 2000 to 2007. This has spurred one of the largest market bubbles not only in the real estate sector, but also in the securities and debt markets sectors.

The biggest problem with leveraging and trading on the margin is precisely the deregulation. An example of this can be taken with debt instruments - collateralized debt instruments and contracts for difference. The deal is unlike a classic debt instrument until the economy is working with full force. But with a fall the price of the instrument that is the basis of this derivative acquires an obligation that is very large.

We have an example in the case of Quinn Group and the purchase of such contracts in cooperation with the Anglo Irish Bank. With the collapse in Anglo Irish Bank's stock prices, the Quin Group was forced to pay \$ 2.7 billion to the bank and went bankrupt. Derivatives are usually very poorly regulated.

The most prominent example of the lack of control by regulators is the case of collateralized debt instruments and their role in the crisis of 2008. The trading volume of these instruments that were considered funds-carrying cash inflows began in 2002 and 2003, although the rating agencies have reduced the ratings of many of these securities.

Already in 2006, the amount of these debt instruments was \$ 500 billion, and by 2007 it grew to \$ 1.4 trillion.

Due to the lack of control by regulators, many of these instruments contained properties that ceased to pay cash in the form of interest, however, however, the rating agencies gave high credit ratings for most of 2004 to 2007 (usually the highest possible AAA rating) . The oldest types of such bonds were diversified and contained multiple sources of funds such as revenues from issuance of vehicles, mortgage income, interest income from student loans and interest income from credit cards.

The point of this was to diversify the sources of funds as broad as possible and to reduce the idiosyncratic risk. But, due to the attractiveness of the real estate sector, almost all subsequent such instruments were directed towards real estate mortgages.

Around 2005, as this market continued to grow, subprime mortgages became a favorite choice for investment banks. They begin to mark 55% of all issued debt instruments of this kind.

Wall Street issued from 2003 to 2007 nearly 700 billion dollars in such debt instruments that target subprimary mortgages. With the popularization of these instruments, the volume of their trading has also increased.

More than a few tens of billions of dollars were traded daily, and the investment banks' share was particularly significant. They often exhibited through the process of issuing the stock exchange through an initial public offering, as many agreed to buy out all those bonds that the market would not to absorb them.

But the source of the problem was mostly that investment banks used margin trading to increase the volume of their positions. Most of the investment banks were in charge of over 30-1 (the ratio between total assets and total capital). Investment banks like Lehman Brothers and Bear Stearns who were most indebted imploded during the economic downturn, and the Bear Stearns bank was bought by JP Morgan Chase for \$ 2 a share.

What is important is that the risks were not understood before the crisis and the scenario was not covered where a large number of people would not be able to repay the mortgages. One part of the problem was the commercial banking system which increasingly reduced the necessary conditions for to get a loan.

The eroding of standard values for obtaining a credit arrangement has contributed to a significant reduction in the creditworthiness of the credit engagements, and hence to the solvency of the bonds that are composed on the basis of multiple credit engagements. It should be noted that the control system inside the banks was particularly weak, and risk managers apparently were not willing enough to do their job. With the clearance of debts of this scale, the work of financial institutions that became ultimately victims of finance s crisis.

We can understand on the basis of this information that the bank's control system is one of the most important systems in any financial and non-financial institution. In this paper we are focused on financial institutions, because they epitomize that system of managing foreign assets and possession of assets that are 30-40 times greater than the amount of their own capital. Such a ratio between own and other assets is not only detrimental to individual organizations, but also affects the systemic level, since competition encourages nies to follow the footsteps of competitors and copy their strategies to attract customers.

The result is a global recession that has sometimes threatened the global economic system, primarily due to the correlation of market movements, but also the connection between global institutions and their exhaustive co-operation.

3. SYSTEM RISKS FROM THE INJURY OF CONTROL AND HIGH LEVERAGE

The systemic risks of lack of control and leverage became apparent for people not involved in finance primarily after the global economic crisis of 2008. But an isolated incident in 1998 triggered by the crisis in Russia is one of the most important lessons about how and isolated incidents can lead to systemic risk.

The Hedge Fund LTCM in 1998, using leverage, managed to acquire positions worth over \$ 125 billion at that time, or with a value of \$ 182.35 billion in 2018. The biggest problem was in linking this fund to the world's largest investment banks, but also commercial banks.

Most of the money traded by the fund was given for trading on margins by investment and commercial banks. With the deepening of the crisis in Russia (due to the high exposure of Russian government bonds) and the devaluation of the ruble, the value of these bonds in dollars fell sharply. But the quantitative models that managed the fund showed that the situation would get a reverse course.

However, at the end, additional funds from the banks were obtained, but bond prices continued to decline. The same happened with other fund investments, whereby the initial \$ 125 billion invested in 1998, a very small proportion could have been withdrawn by the fund and returned to the banks.

Investment banks and commercial banks faced a loss of their assets and huge losses. Because of their exposure to the leverage to acquire the assets they borrowed from LTTC, they themselves felt a reduction in their liquidity. One of the biggest fears of financial authorities and regulators at that time is a lively reaction to the massive sale and liquidation of positions.

This would have an effect on the liquidation of the positions of many investors, which would only multiply losses. Systemically important institutions at the same time would have to sell other assets on the markets in order to pay off their loan commitments at the time of the difficult economic activity and panic that the situation would only get worse.

Because of this, a LTTM was withdrawn from bankruptcy with the investments of over 20 banks that were associated with LTTC as trading partners or borrowers. Toa stopped the initial roll of negative news and the situation lost its tension.

We can also say the same about insurance of credit arrangements by which insurance companies can insure the credit arrangements of banks and non-bank institutions that have crediting activities, which makes the insurance company obligate to pay to the bank or non-bank credit organization in case of non-payment of the loan by the person who lends money.

With these instruments and the massive acceptance of commitments and risks, the insurance giant AIG in 2008 was on the verge of bankruptcy. The reason was the large credit insurance from the US and European markets.

With the emergence of these instruments, several anomalies in the credit markets have been achieved:

- Insurance companies have taken great risks
- Commercial banks have reduced credit standards primarily because they thought they were insured in case the loan was not returned
- Suppliers and commercial banks have reduced their controls
- Suppliers and commercial banks have eased the conditions under which risk management works
- Suppliers and commercial banks have started lending a lot of money and committing themselves to big obligations
- Investment banks started trading these instruments through leverage

As we can see the crisis, the AIG started to take a systematic character, since every crisis threatens the world financial system as a whole. First of all, trading in money and cash equivalents, as well as other financial assets and instruments, always takes place on globally and among a number of entities that collaborate among themselves.

Because of this, AIG was rescued by the Fed by injecting \$ 80 billion in capital because the global financial system was in jeopardy. A large number of US and European banks, if not paid by AIG for the loan arrangements they insured, would be left without the means to pay off their depositors. A timely response from the Fed prevented a major crisis.

The biggest problem in today's world is that all financial actors are connected to each other regardless of the geographical position, the degree of capitalization, the degree of indebtedness, and many other important features.

It is this integration of the global financial system that makes it vulnerable in crisis situations, because if only one institution can not pay off its obligations it covers many other institutions with which it cooperates.

4. LECTURES FOR THE REGULATORS AND CONTROLLERS FROM THE FORMER FINANCIAL CRISIS

One of the main lessons to be learned is that there is a need to limit leverage to a lower level and to limit the risk of co-operation with risky financial and non-financial institutions. Regarding the issue of the amount of leverage, certain regulatory definitions, yet the risk of integration of the financial system can not be avoided.

It is necessary to create conditions for creating a paradigm of how many transactions an institution can enter into with regard to the capital it has available. Here, the Central Bank should enter with its monetary instrument in order to "tighten" the borrowing process and to control interest rates not to go to a very low level, which may encourage the creation of a new bubble in a certain type of property. Also, regulators and controllers need to realize that isolated incidents have an impact on the system as a whole and should not be seen only through the idiosyncratic prism.

The isolated incidents and losses on them may encourage the sale of other assets in order to cover the losses and pay off creditors which would encourage a fall in the value of the instruments on the capital markets which would create a situation of panic and divestment of a large the number of assets. Regulators and controllers must react to each risk sign and not allow the risk of becoming more extensive.

It is important to control the risks and to act at any chance to make a greater risk. But what's very important is to make a framework in which financial and non-financial entities will have to operate.

There are several needs for this to be implemented:

- The need to control the leverage
- Reduction of risk from trading partners and lending companies
- Reduction of the risk of spreading idiosyncratic risk in systemic risk
- Reducing the risk of insufficient control
- Reduction of the risk of liquidity impairment
- Reduction of the insolvency risk

Systemic insolvency is the biggest nightmare of the global financial system. But we must note that because of leveraged levers and easy regulation over trading, the global financial system was at risk several times in history.

The causes of these recessions are always the same, which is the lack of control and leverage. The problems with these phenomena are always complex and the need to solve is enormously great. The reason for this is the systematic form of leverage and the lack of control.

The psychological moment of failure of control in one institution leads to weakening control in other institutions, primarily because of the effect of "market adjustment". An example of this is with credit institutions before the crisis of 2008.

With the failure of the control process of certain institutions and the easing of the way to credit arrangements by lowering the standards, conditions have been created for lowering the standards of other institutions, primarily due to the effect of competition.

Regulators and controllers must acquire instruments that will limit these negative effects and cause financial discipline, even at the expense of growth. First of all, this growth is illusory, and the dangers that it hides and the risks it faces institutions, but also the system is enormous.

CONCLUSION

Financial leverage and the lack of control are the greatest dangers facing the global financial system. They must be canceled, or at least controlled in order to have a financial system that will not be in jeopardy with the idiosyncratic risk that passes into systemic risk, excessive borrowing and lack of control over the management of financial assets.

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