CHAPTER 1: INTRODUCTION

1.1 Introduction

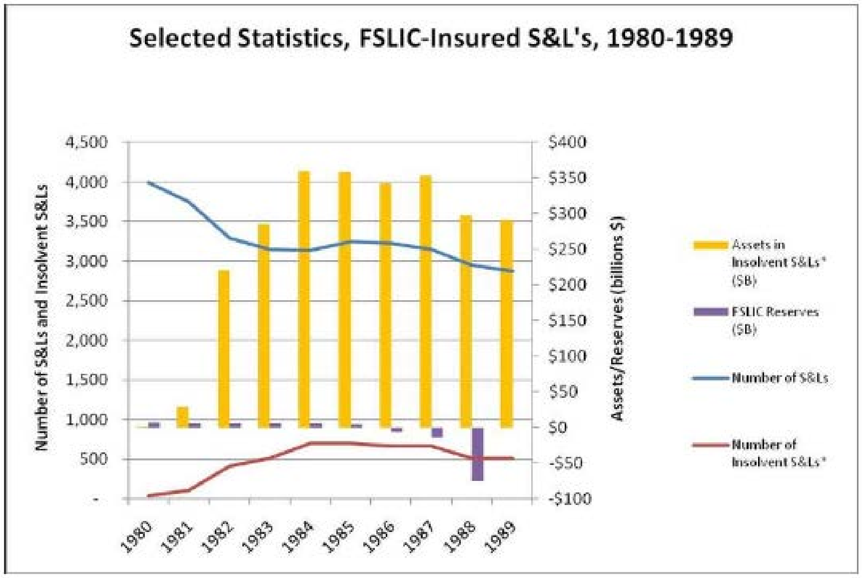
Within this contemporary business world, it has been observed that there is a growing interest of dwindling movement in the economic trends that are not just in the UK but has spread over different locations around the world. There are different sources of funding that are observed by businesses such as the owner's funding and the borrowed finding (debt). According to Jouida and Hellara (2018), the financial leverage is referred to as the utilisation of financial debt in the organisation rather than using fresh equity to meet the requirements of the business. The following research is aimed to assess the impact of financial leverage within the banking industry of the UK. The research conducted by Towo, Mori, and Ishengoma (2019) has claimed that the use of debt is necessary for the industry, however, it creates the increasing liabilities on the business that may not be effective for the long term profitability. According to the assessment of Lee et al (2017), the accurate combination of debt and equity is considered to be the most effective element of financial planning in the organisation. Leverage is referred to as the borrowed money or the funds that are taken for investment. Gatsi, Gadzo, and Oduro (2016) has also added that the use of debt and the capital increases the total earning of the organisation if the return of investment exceeds the cost of financing in return.

Based on the arguments of Das (2017), it is effective for the organisations to take investment decisions in the organisation that is the combination of the debt and equity for the development of an accurate capital structure. It is essential for the development of long term financial stock for the company and also supports maximizing shareholders' wealth. Similarly, another study conducted by Thi Bich Ngoc, Ichihashi and Kakinaka (2019) has also argued that the financial experts have been investigating the issues of a firm's financial performance using the theoretical approaches. The researchers have also investigated the relationship between the leverage and financial performance of the firms in this regard (Afolabi et al., 2019), (Schoen, 2017). Moreover, the study conducted by Chechet and Olayiwola (2014) has also investigated the combination of the financial and non-financial organisations that has different methods of investment. However, the investment methods of both of these institutions are different in this regard. Based on the investigation of the financial sector of the UK, it has been observed that within the year 2018, the financial service sector in the UK has contributed nearly £132 billion to the UK economy Mohamed (2016).

Moreover, Maer and Broughton (2012) have also added that it is nearly 6.9% of the total economic output. It is one of the largest sectors in London that has a major market share and has an attractive output for the county's economy. According to Timmer (2018), there are nearly 1.1 million jobs in the financial services sector of the UK that equals 3.1% of the total jobs in the UK. Additionally, the exports of the financial sector in the UK is comprised of £60 billion in 2017 and £15 billion within the imports of the country. The following investigation will be based on the top 5 banks in the UK that are HSBC, Barclays, Halifax, Natwest, and Lloydds. These banks have been contributing a major share to the UK's economy. The following study has aimed to undertake the investigation based on financial institutions such as the banking sector in the UK that has its major applications within the current time. The following chapter has provided with the introduction of the study and has developed the relevant background and objectives to be achieved further in this research.

1.2 Research Background

The concept of financial leverage has been observed in the year 1933 according to Lin, Schmid, and Xuan (2018). The financial leverage is referred to the debt taken by the organisations to maximise their assets and increase the return on equity. According to the analysis of Sodeyfi (2016), the organisations have been using the system of financial leverage for a long time and has been gaining benefits by increasing their profitability. This aspect is being used by the organisations and has been providing different benefits in this regard. Gatsi, Gadzo, and Oduro (2016) have provided with the assessment that within the context of the banking system, the financial leverage is referred to as the borrowed money that can be used for financial purposes mainly for investment. The study of Corp2020 (2012) has provided with the presence of financial leverage. The study has highlighted that the organisations face several issues and undergo the financial crisis after gaining a higher amount of loans and leverages from other investors. Despite having a positive response, the leverages also have a negative attitude towards the organisations if the company is unable to pay the debt. According to Anagnostopoulou and Tsekrekos (2017), some of the major examples of the financial debt crisis can be observed in Latin America. The country has faced a severe issue of the debt crisis in the year 1980 that was not the result of the corporations but was the debt by the sovereign governments. The heavy borrow has resulted in having an insignificant response from the financial institution and the country faced severe losses. Additionally, the US saving and loan crisis is also under consideration and can be used as an example for understanding the issues of financial crisis due to the presence of these loans.



Moreover, the Asian debt crisis can also be considered for assessing the aspect of financial leverage. This crisis was put forward in the year 1990s and had severe consequences in this regard. According to the arguments of Afolabi et al (2019), financial institutions undergo the process of investment that is comprised of the combination of debt and equity to gain profitability. Additionally, it has also been assessed that the use of financial leverage is common within the banks for carrying out investment in different areas and gaining higher returns. Moreover, it has also been common for the non-financial institutions that can be effective for gaining favourable returns and having certain benefits for the short term and long term investment. Adenugba, Ige, and Kesinro (2016) have argued that if the firms are unable to repay the debt, they also may reach to the bankruptcy and can also face severe issues in terms of credibility and reliability of the consumers. Moreover, different ratios can be used by the investors for gaining an accurate understanding of the debt and equity to be used in the organisations while carrying out the investment decision according to Bhardwaj (2018).

Similarly, the debt ratio and equity ratio is also assessed by the investors while carrying out the activities for accurate investment.

1.3 Problem Statement

One of the most important decisions made by financial institutions is to make financial plans for investment. According to the arguments of Woods, Tan, and Faff (2019) the most effective financial plan is comprised of the proper ratio of debt and equity that is required for investment. However, it is highly difficult for organisations to undertake the operations that are comprised of debt and equity. Hussein and AL-Musawi (2017) have argued that the constant struggle of managing long term financing also leads towards the maximisation of shareholders' wealth. The aspect of debt and equity ratio has gained much attention from the researchers such as Harjoto (2017) and Russell Briggeman and Featherstone (2017) who have investigated the situation faced by the organisations as a result of having debt. Moreover, Sari and Wiksuana (2018) have also argued that the increasing debt of the company also affects its liquidity at a higher rate. Several studies have been carried out on the topic of debt and equity ratio but the financial institutions are still not aware of the most suitable methods to be used for their long term and short term investment.

According to the arguments of Ali et al. (2019), the increasing debt of the company is also very risky for the organisations as it limits the opportunities for growth and the overall revenue generated by the organisation. Despite having several benefits, debt financing and financial leverage have different drawbacks that are generally faced by the organisations in this regard. Therefore, the problem that is under consideration in the following study is to investigate the impact that is there on the financial institutions as a result of the debt and financial leverage used by the organisations. According to the arguments of Xinyuan, Nan, and Yufei (2017), the increasing debt of the organisations may also lead towards the obligation of having more payback and also having penalties if the company fails to pay the debt on time. Therefore, it has been observed that the organisations face several issues due to the reason of having debts.

1.4 Research Aim and Objectives

The core aim of the study is to investigate the effects of the financial leverage possessed by financial institutions. The researcher has aimed to assess the potential impact of the financial leverage on these financial institutions. The study has been designed for the financial sector of the UK. It has been assessed that the researcher has aimed to investigate the practical assumptions and outcomes of the financial sector concerning the factor of financial leverage. The objectives of the study have been provided as under;

- To study the concept and significance of financial leverage
- To identify factors affecting the performance of an organisation
- To evaluate the impact of financial leverage on the banking performance of the UK
- To provide recommendations on the improvisation of banking performance through financial leverage in the UK.

1.5 Research Questions

The research has answered the following question within the following research;

"How the production of banking companies is influenced by financial leverage?"

However, the research questions to be answered in the following study are provided as under;

- What is the concept and significance of financial leverage?
- What are the factors affecting the performance of an organisation?

- What is the impact of financial leverage on the banking performance of the UK?
- What are the recommendations on the improvisation of banking performance through financial leverage in the UK?

1.6 Significance of the Study

The following study has made contributions to the financial sector in the UK as well as other countries that are depending on the financial sector. According to the study of Dey, Hossain, and Rezaee (2018), the financial and non-financial organisations look forward to adopting the most feasible method of investment in the organisation that is combined with the accurate ratio of debt and equity. However, different issues and concerns are faced by the organisations towards this method of investment. As the financial sector of the UK has been contributing a major share towards increasing the economy of the country, the following study supports them in making the investment decision by highlighting the causes and effects of the financial leverage in the organisations. The study has also facilitated the investors and the financial decision-makers of the organisation to invest in favour of the organisation. The study of Pinto and Joseph (2017) has argued that the limited research on the impact of financial leverage has created the hurdles towards investment decisions as they are not aware of the outcomes. Therefore, the following study has contributed to the financial institution of UK and also has provided benefits to the financial intuitions of other countries for taking investment decisions towards financial leverage.

1.7 Rationale of the Study

The limited research on the topic of impact of financial leverage on the organisations has led to the discovery of different issues regarding the financial outcomes and the investment decisions. According to Sodeyfi (2016), the organisations look for the methods that can bring about profitable changes in the company and can also provide higher return on investment. However, the methods of investment are also based on debt-equity and the financial leverage that can be opted by the organisations for investment purposes. The financial and non-financial organisations seek the method of financial leverage to carry out the short term and long term investment according to the analysis of Abubakar (2016). However, they are not aware of the outcomes that can be gained by these methods of investment. The rationale behind the following investigation is to address the potential impact of the financial leverage on the financial institutions. The study has been associated with the location of the UK and has been aimed to address the issues of top banks in the UK like HSBC, Barclays, Halifax, Natwest, and Lloyds. These are considered to be the best banks in the UK that share a higher share in the country's economy. Furthermore, these banks also look forward to the most feasible methods of investment that can provide a higher return and higher profitability. Therefore, the study addresses the impact of financial leverage on the financial institutions that are there in the UK.

1.8 Structure of the Study

The study has been designed to investigate the impact of financial leverage on financial institutions in the UK. The study has been divided into different sections that have been segregated accordingly.

- The first chapter has provided with the background and introduction of the study and has set the stage for the objectives to be achieved.
- The second chapter has outlined the reviews and arguments of different authors by presenting the review of the literature. This chapter has also highlighted the conceptual and theoretical framework for investigation.
- The third chapter has highlighted the selected methodology for an investigation that is most appropriate for answering the research questions.
- The fourth chapter has evaluated the results and has assessed it using the method provided in the previous chapter.
- The fifth and last chapter has addressed the conclusion and recommendation of the following investigation.

1.9 Chapter Summary

The introductory chapter has highlighted the concepts and the background information of the following research. The researcher has provided the objectives and questions for the following investigation. After the completion of the chapter, it has been concluded that the lack of research on the financial leverage for the financial institutions has been creating several issues for the organisations and the bans to make the investment decision. They are unaware of the impact of the financial leverage of the organisations and their impact on the return of the company. The next chapter is the literature review that will address the related literature resent on the following study.