CHAPTER 2: LITERATURE REVIEW

2.1 Introduction

This chapter includes the review of different literature which is related to the topic of the study which is the impact of financial leverage over the performance of banking in UK. For conducting the study, the studies that are conducted all over world are included in the study the concept of financial leverage along with its significance is discussed in the chapter in the light of previous literatures. In addition to this there is a detail regarding the concept of organisational performance as well as the importance of analysing it is also present in the study. This chapter also covers the determinants of financial leverage and financial performance by focusing over the relevant literature. After that the chapter also includes the overview of banking sector of UK along with the impact of financial leverage on the banking performance of the UK and the importance of financial leverage in the production of banking companies. The theories which are relevant to the study are also included in the chapter along with the framework which is used in order to conduct the study.

2.2 Concept of financial leverage

Financial leverage is defined as the process in which debt is being used in order to buy more assets. It is analysed that leverage is engaged in order to enhance the return on equity, however, there is too much amount of financial leverage which mainly enhances the failure of risk, which makes more difficulty in repaying the debt. The formula for the financial leverage can be calculated as the ration which is used for total debt to the total assets (Lin, Schmid and Xuan, 2018). As the particular quantity of the debt towards the assets enhances, the quantity of

financial leverage also increases. Financial leverage is known to be favourable when they can be used for which debt can bring together to generate the returns greater as compared to the interest expense which is associated with the debt (Anagnostopoulou and Tsekrekos, 2017). There are number of companies which relies over the financial leverage instead of acquiring more equity capital that would help in reducing the earnings per share of the shareholders.

Furthermore it is analysed that the financial leverage results from using capital that is borrowed which is considered as the source of funding while investing for the expansion of the asset base of the firm and generate the returns over the risk capital (Afolabi, 2019). Financial leverage is considered as the strategy for investment of using the money which is borrowed, specifically in the use of financial instruments or capital which is borrowed and helps in increasing the potential return over an investment. It is analysed from the study by Bhardwaj, (2018) financial leverage is known as the amount of the debt which is used by the firm for financing the assets. When any property, company or investment is considered to be highly leveraged, then it means that this item has more debt as compared to equity. Leverage is known as use of borrowed capital or debt which is used in order to undertake the project of investment. It is analysed that the investors that not tends to use leverage directly have several other ways to access the leverage indirectly (Adenugba, Ige and Kesinro, 2016). They allows in investing the companies which use leverage normally in their business in order to finance as well as expand the operations without enhancing the outlay.

2.3 Significance of financial leverage

As per the study by Choi, Donangelo and Kim, (2019), it is analysed that financial leverage is considered to be very significant as the main advantage of financial leverage is its earnings that are enhanced and tax treatment that is favourable. There is a possibility that financial leverage can allow the entity in order to earn a disproportionate amount over the assets that a person or business owns. In addition to this another advantage of financial leverage is its favourable treatment of tax, in which there are several tax jurisdictions, the expense of interest is tax deductible that helps in reduction of the net cost for the borrower. However it is also analysed that in financial leverage there is a possibility in which there are disproportionate losses in which the amount which is related to interest expense overwhelms the borrowers if the borrower is not able to earn sufficient returns in order to offset the interest expense (Sajid, Mahmood and Sabir, 2016). This is considered as the particular problem while the interest rates enhance or the rate of return from the assets declines.

It is analysed that the unusual large swings in the profits are mainly caused with the help of heavy amount of leverage which enhances the volatility of the stock price of the company. This is considered as the problem when the operations of accounting should have to be performed for stock options that are issued for the employees, since there are high volatile stocks which are regarded as a valuable and creates a higher compensation expense as compared to the shares that are less volatile (Maia, 2018). Financial leverage is known as an approach which is risky in the businesses which are cyclic or in such businesses in which there are few barriers for entry, since sales and profit are more likely for fluctuating the considerable from year to year, which enhances the risk of bankruptcy over time (Al Momamni and Obeidat, 2017). In short it is analysed that the financial leverage is said to be very significant and it can be earned outsized

returns for the shareholders as well as it also presents the complete bankruptcy if the cash flows fall below the level of expectations (Iqbal and Usman, 2018). The concept of leverage can be used by both investors as well as the companies. The investors can mainly use financial leverages in order to significantly increase the returns which can be provided over an investment. They are able to lever the investments with the help of using different instruments in which operations, margin accounts and futures are included. The companies are also allowed to use financial leverages in order to finance their assets (Sajid, Mahmood and Sabir, 2016). So, it is analysed that rather than issuing the stock towards the raise capital, the companies are used for debt financing in order to invest in the operations of the business for the attempt by which the value of stakeholder can be increased.

2.4 Concept of organisational performance

Organisational performance is considered as the process which involves the analysis of the performance of the company against the goals as well as objectives. It is also evaluated that the organisational performance consist of the real results as well as outputs which are compared with the outputs which are intended. The main focus of the business analysis is over three main outcomes in which shareholder value performance, financial performance as well as market performance is included (Ringim, Dantsoho and John, 2017). There are several professionals which focus over the organisational performance in which the strategic planners are on top. The organisational performance is very similar to the organisational effectiveness, whereas in organisational effectiveness the broader area is covered (Oladimeji, Akingunola and Sanusi, 2017). Organisational performance is known as the actual output or it is regarded as the results of the organisation that are measured against its intended outputs.

The concept of the organisational performance is considered as the comparison of the goals as well as objectives of the organisation along with the actual performance in three main areas which includes the financial performance, performance of the market as well as the value of the shareholder. Financial performance is known as the results of the organisation with regard to the return over the investment as well as return over the assets. The market performance is known as the ability of the company in order to make as well as distribute the output in such way which is cost effective and set the price which returns the particular amount to the suppliers. In addition to this, the performance of the market refers to the ability of the company for meeting the demands as well as expectations of the consumers which are related to the product or services that are being produced or offered (Al-Swidi, Faiz and Gelaidan, 2019). There are number of organisations that measure the performance of the market with regards to how great a share of the market which is possessed relative to the competitors and some are measured by the ability of achieving the social responsibility. Whereas, shareholder value is known as the value of the person by which they holds the shares in the organisation that they possess (García-Sánchez, García-Morales and Bolívar-Ramos, 2017). So, these three measures are mainly used in order to determine that either the goals of the organisations are achieved or not. Itself organisation does not perform any work but the managers of the organisation are performing the works that are assigned along with the combination of the performed works which is known as the performance of the organisation (Rehman, Seth and Shrivastava, 2016). Along with the resources which are used to run the business, the organisation get several things as the results like effectiveness, development, efficiency as well as participant satisfaction.

2.5 Significance of analysing banking performance

Banks plays a basic role in the development of the economy of the nations as they are responsible of the wielding the control to the large extent over the supply of the money in circulation which are considered as the main stimuli of the economic progress. Economic development is considered as the dynamic as well as a process which is continuous that is mainly dependent over the mobilisation of the resources, operational efficiency as well as investment of different segments of the economy (Chen, Jaw and Wu, 2016). Therefore a strong banking sector is considered to be very important for the growth as it helps in creating the jobs, generating the wealth, eradicating poverty, enhances the gross domestic product growth as well as entrepreneurial activities. As the sector of banking is regarded to be very important for the economy of the company, its efficiency is considered to be very important (Jyoti and Rani, 2017). The efficiency can be ensured with the help of healthy financial system along with the efficient economy, the banks should must evaluate as well as analyse carefully.

The banks plays a major role in helping the business organisation with the help of rendering the great range of the products as well as services. Therefore, it is very important for the banks to analyse the performance of the banks to determine the contribution for the development of the business (Shafiq, Lasrado and Hafeez, 2019). It is inevitable and the banks continuously attract the important devotion from the scrutiny as well as public with the help of financial regulators as there is a need to evaluate the banks in effective and efficient manner. Along with the supervising institutions, regulators as well as management bodies of the banks, the clients if the banks are also considered as the main concern regarding the stability and sustainability of the financial institutions (De Guimarães, 2016). There are several reasons which can be used in order to evaluate the performance of the banks in which the most important reason

is to determine the operational results of the banks as well as the overall financial condition, measuring the quality of the assets, managing the quality as well as efficiency and the achievement of the objectives (Kelly and Cameron, 2017). The analysis of eth bank performance includes gathering of formal as well as informal data which can help the customers as well as sponsors in order to define as well as achieve the goal. The banks are expected to provide the evidence for the credit operations as well as financial flows as it impacts the growth as well as economic development of the country (Alsyouf, et al. 2018). However it is evaluated that the performance cannot have easily measured since there are number of the products as well as services that are intangible in the nature.

2.6 Determinants of Financial Leverage

For every business, the maximization of profits is consider as one of the common goal, for which organisations makes different financial decisions to attain their objectives related to business profitability. As per the study of Ibrahim and Lau (2019), the type of financial decisions that firm normally make are short-term and long-term decisions. In this regard, long-term financial decisions of the company are commonly associated with capital structure, and are mainly revolves around dividends issuance and capital formation. On the other hand, short-term financial decisions are mostly linked with company's working capital and liquidity. In this context, when it comes to making financial decisions of the company, the decisions related to financial leverage holds huge importance for the firms (Hussein and AL-Musawi, 2017). The growing interest in the topic of financial leverage has arose due to its significant impact on wealth to shareholders, profitability, and overall value of the company. Therefore, the examination of financial leverage determinants is important for the policy making of the

company. In accordance with the study of Onyenwe and Glory (2017), the three of the most common determinants or measures of financial leverage are Debt to Asset Ratio, Debt to Equity Ratio, and Interest Coverage.

2.6.1 Debt to Asset Ratio

Debt to asset ratio is considered as another key indicator of financial leverage of the company, which depicts the proportion of company's total assets that are financed by creditors (Rahman and Rahman, 2017). Similarly, as per the study of Malm and Krolikowski (2017), debt to asset ratio is one of the useful way to determine company's financial leverage, as it portrays the proportion of assets that is funded from borrowings in comparison with the proportion of resources that are funded by investors. In this regard, the higher ratio explains the higher degree of leverage, which ultimately expose the company to high financial risk. Therefore, debt to asset ratio is an important determinant of company's financial leverage.

2.6.2 Debt to Equity Ratio

The study conducted by Kuswanto, Raharjo and Andini (2017), explains debt to equity ratio as a ratio that indicates the relative percentage of debt and equity that is used to funding the business operations. Since, firm's decisions pertaining to financial leverage is mainly linked with the allocation of debt and equity to run the business operation, hence debt to equity ratio has been regarded as a key sign of financial leverage of the company. According to Iqbal and Usman (2018), debt to equity ratio has a huge implication for the shareholders risk and dividends, which eventually influence the market and capital value of the company. Hence, debt to equity is the most essential measure or determinant to consider while examining company's financial leverage.

2.6.2 Interest Coverage

Interest coverage as another important determinant of financial leverage is generally regarded as coverage ratio (Oketch, Namusonge and Sakwa, 2018). As per the same study, this ratio explains the ability of the company to meet its fixed financial debts. According to Greenwald (2019), the main rationale of conducting interest coverage ratio is identify the number of times a firm's EBIT can cover its interest payments. In this regard, the higher ratio of interest coverage shows that company is more debt-free or solvent, which indicates the organisation capability to service debts from their operating incomes.

2.7 Determinants of Financial Performance

The firm's finance and investment decisions are closely analysed by major actors in financial market, which includes investors, creditors, and potential investors (Sharma, Jadi and Ward, 2020). For that purpose, different financial market actors tends to utilise wide range of financial ratios to better analyse the firm financial performance, and to measure how effectively the firm is managing its resources. According to Purwaningtyastuti, Titisari and Nurlaela (2018), some of the most common ratios that are generally viewed as the key determinants of company's financial performance are earning per share (EPS), return on equity (ROE), net income margin, and liquidity (Current Ratio).

2.7.1 Earnings per Share (EPS)

This ratio represents the proportion of the overall firm's profitability that is distributed to each individual share of the stock (Batchimeg, 2017). In accordance with the same study, the earning per share ratio carries out huge importance for investors, and for individuals who practice trading in stock markets. The high ratio of EPS reflects the higher company's

profiability (Mohapatra, 2019); hence, it is the important determinant to consider while measuring company's financial performance.

2.7.2 Return on Equity (ROE)

Return on equity (ROE) is considered as another important ratio that is used to predict the financial performance of any company. As mentioned in the study of Rai et al. (2018), ROE is a profitability ration that shows the amount of company's profitability that is generated as a proportion of shareholder's equity. According to Daly and Frikha (2017), the ROE ratio is an important measure of company's performance, as it explains the company capability to generate cash internally.

2.7.3 Net Income Margin

Net income margin is also recognised as profit margin, which explains the overall profitability of the company. This ratio measures the net profit or income that is generated as a proportion of company's revenues (Ferrouhi, 2018). In other words, net profit margin refers to the proportion of revenues remained after all the interest, preferred stock dividends, operating expenses, and taxes have been excluded. Hence, net profit margin is one of the most useful financial measure to analyse the performance of any business.

2.7.4 Liquidity (Current Ratio)

Current ratio is viewed as one of the most prominent metric that is commonly utilised across different industries to measure the firm's short-term liquidity relative to its impending liabilities and available assets (Matar and Eneizan, 2018). As per the same study, this ratio reflects the ability of the company to generate sufficient amount of cash to pay-off all of its debt. Therefore, this capability of the company is commonly viewed as an important measure to assess financial health of that company.

2.8 Overview of banking sector in UK

It is observed that the economic output of the country have been slowed by the end of 2018 by 1.4% which is recorded to be the lowest rate after 2011. This slowdown was observed due to the contraction in the investment of the business and widens the net trade deficit which has been dragged down output from the household consumption which is stable and is supported by the annual wage growth of 3.5% which results in expanding the spending of the government (Garavan, et al. 2020). During such years the annual rate of consumer price inflation have peaked in the past years at 2.1% which was just above the target of Bank of England. The rate of official bank was raised from 0.5 to 0.75% (Bakotić, 2016). The rate of unemployment continues to fall while these years to 4% while the employment records the height of 76.1%. The household saving ration of gross saving for the total disposable income was 4.8% in the final quarter of 2018 which maintains the historically low trend from past two years (De Guimarães, 2016). It is also analysed that the consumers as well as business confidence measures have weakened while 2018 which have amid continued uncertainty which is linked with the economic as well as trading impacts of proposed withdrawal of UK from the EU (Ringim, Dantsoho and John, 2017).

2.10 The Impact of Financial Leverage on the Banking Performance of UK

As per the study of Kiet, and Thuan, (2019), financial leverage for the banking sector is the most important element as the banks are usually operating on the fixed amount of profit which is being earned through the interest earned upon the loans provided by the bank. On the other hand, it has also been studied that the banking structure mainly rely over the debt as there are number of sources which provides the cash to the bank and makes it easier for them to

continue their business process (Oketch, Namusonge, and Sakwa, 2018). Sources of money for the banks are the amount being deposited by the account holders, investors, fixed depositors and central banks. Therefore, it makes clear that he banks are also liable to pay interest to those who have invested in the banks. In addition to that, it was studied that the rate of interest that the banks collect from the borrowers and the rate of interest being paid by the banks is different (Sodeyfi, 2016). However, the banks are the bodies which reduces the risk of investors therefore they also pay the lower amount of interest to their investors.

This makes it clear that the probability to earn profit is directly proportional to rate of risk that the investor is going to bear. Furthermore, it has also been studied that the banks usually have staff and procedures to evaluate the risk before providing loans and assure their investment will be recovered in each possible outcome (Bui, 2020). However, if a bank is lacking in terms of evaluating the risk, there are chances that they would have to bear financial losses in near future which will directly affect their performance. In case of UK banking sector, it was studied that the leverage of banking sector is higher than the other countries as most of the people in UK are relying over debt even for their basic necessities of life (Elahi, 2017). Therefore, this cycle has increased the rate of risk for the banks operating in UK.

2.11 Importance of Financial Leverage in the Production of Baking Companies

There are sufficient number previous studies that have identified financial leverage as an important component for the production of banking companies. As mentioned in the research of DeAngelo and Stulz (2013), financial leverage in banking industry is considered to be much higher in comparison with any other industry. The high financial leverage is normally view as a positive sign for firm value, as it tends to enhance the performance and efficiency of the firm.

However, high financial leverage ratio sometime lead towards high agency cost due to different interests amongst debt holders and shareholders (Ebiringa and Ezeji, 2012). Therefore, the significance of financial leverage is highly associated with the identification of optimal level of leverage that firm's needs to maintained. However, in the context of banks, having higher leverage ratio is considered to be safer as compared to any other company. This is mainly due to the reason that banks commonly utilise their own capital to make investment or loans or sell-off it's most risky and leveraged assets (Dey, Hossain and Rahman, 2018). The same study identifies financial leverage as the most crucial option for banks to have for diversifying its financing risk, and to ensure the maximum production of the bank.

According to Abubakar (2015), high financial leverage is highly important and optimal element of banks capital structures, when liquidity is valued at premium because of demand for certain access to capital. Moreover, the high competition in the banking industry often lead towards squeezing liquidity of the bank, and loan spread decreases equity value; thus, having the optimal level of financial leverage is highly critical for banks to sustain their competitiveness in the market, and to enhance their production. As per the study of Kalemli-Ozcan, Sorensen and Yesiltas (2012), financial leverage has the huge potential to enhance overall bank performance, if it is well managed and structured. Therefore, it is the responsibility of the bank's management to manage financial leverage appropriately, and ensure optimal level of leverage to accomplish desire business objectives. Similarly, the study carried out by Kiet and Thuan (2019), stresses on the importance of identifying the most ideal level of leverage for banks to make sure that financing risk should not exceed too far from the tolerable limit, which as a result may lessen the returns to shareholders and negatively affects the overall profitability of the organisation.

Conclusively, financial leverage holds huge importance for the production of banking companies.

2.12 Theoretical Framework

2.12.1 Trade-off Theory

The trade-off theory holds the view that organisations must need to manage ideal level of debt ratio by analysing the cost and benefits of borrowings. As stated in the study of Onyenwe and Glory (2017), the concept of trade-off theory explains that ideal level of firm debt ratio can be determine by a trade-off between the tax advantage and bankruptcy cost of borrowing. In this regard, trade-off theory suggest that companies can consider borrowing up to the extent where tax marginal value protects on extra debt is just balance by the increase in current value of probable cost of financial distress. This theory assumes that company is likely to have an ideal level of capital structure on the basis of trade-off between benefits and cost of using debt (Nicodano and Regis, 2019). Thus, by using this approach companies can identify the appropriate level of financial leverage.

2.12.2 The Irrelevancy Theory

The irrelevancy theory posits that financial leverage does not make any significant influence on overall value of the company, if it is not faced with distress cost and income tax (Al-Kahtani and Al-Eraij, 2018). This theory is mainly based on the belief that there are efficient markets, and investors does not experience any tax and transaction cost while selling and buying securities. Acccoring to Udobi and Iyiegbuniwe (2018), the irrelevance theory also postulates that market value of any company is identified by its capability to earn and risk that is associated with its underlying assets. Hence, in this context the WACC needs to be stay constant. Moreover, this theory also argues that company's value is not influenced by its capital structures, but it's the

asset earning capability that determines the firm value. However, the overall view of this theory is highly criticised as it has not consider the element of distress costs and income tax.

2.13 Conceptual Framework

Independent Variables **Dependent Variables**

The above-mentioned conceptual framework highlights key dependent and independent variables of this study. As highlighted in the above presented framework, the independent variable of this study is financial leverage, whereas the dependent variable is financial performance. In order to examine the impact of financial leverage on financial performance of the banks, the sub variables of both independent and dependent variables are also highlighted. In this regard, financial leverage is measured through the variables of debt to equity ratio, debt to asset ratio, and interest coverage. On the other hand, financial performance has been measured through earnings per share (EPS), return on equity (ROE), net income margin, and liquidity (Current ratio).

2.14 Chapter Summary

This chapter of the study is providing the review of related literature regarding the financial leverage in banking sector of UK. Structure of the study is being set drafted in a way that the concept and significance of financial leverage is being discussed in order to develop the understanding of the reader about the main aspect of the study. Furthermore, the second element of the study is banking performance, therefore its concept as well as the significance has also been discussed in this chapter. Later to that, their determinants and the overview of UK banks have been provided along with the impact of financial leverage on the banking sector of UK. In addition to that, importance of financial leverage on the banking performance of UK was also discussed before the sections of theoretical and conceptual frameworks.