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THE EFFECT OF FINANCIAL LEVERAGE ON FINANCIAL INSTABILITY: A STUDY OF A SAMPLE OF COMPANIES LISTED ON THE IRAQ STOCK EXCHANGE

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Abstract

This research examines the impact of financial leverage on financial instability in a sample of companies listed on the Iraq Stock Exchange, specifically focusing on Baghdad Soft Drinks Company from 2019 to 2023. Financial leverage, the use of debt to amplify shareholder returns, can lead to increased risks, especially when mismanaged or excessively relied upon. This study investigates the relationship between debt ratios and financial stability indicators, aiming to identify strategies that balance the benefits of leverage with the risks it entails. The research hypothesizes that a higher financial leverage correlates with greater financial instability and increased risk of liquidity problems. Through an analysis of key financial ratios such as Debt-to-Equity, Debt-to-Assets, and Interest Coverage, the study tracks the company's financial health over the period. The findings reveal a gradual increase in debt levels, yet the company maintains relatively low debt ratios compared to industry standards, indicating stable financial management. This study highlights the importance of managing debt effectively to prevent financial distress while also leveraging financial tools for growth. The research offers practical recommendations for companies and policymakers to ensure sustainable financial practices and strengthen market stability, especially during times of economic uncertainty.

Keywords: Effect of Financial, Financial Instability.

Introduction

Financial leverage is one of the fundamental concepts in the field of financial management, representing a strategic tool used to maximize returns on shareholders' equity through the use of debt financing. Despite its economic advantages, excessive or uncalculated use of financial leverage can lead to significant risks to the stability of financial institutions. In light of global economic changes and increasing volatility in financial markets, the impact of financial leverage on the financial stability of companies and national economies has become a focal point for researchers and policymakers. High reliance on debt may exacerbate financial crises, especially when companies face challenges such as declining revenues, rising interest rates, or currency fluctuations.

This research aims to uncover the effect of financial leverage on financial instability by analyzing the relationship between debt ratios and financial stability factors in companies. It also highlights how to achieve a balance between leveraging the benefits of financial leverage and avoiding its associated risks. This contributes to providing practical recommendations to enhance financial sustainability across different environments.

1. **Research Problem:**

Financial leverage is a fundamental tool for maximizing returns; however, it entails risks that directly affect the stability of companies and financial markets. With the increasing reliance on debt financing, especially in large companies and high-growth sectors, a critical question arises regarding the role of financial leverage in enhancing or undermining financial stability. The research problem can be articulated through the following questions: "How does the use of financial leverage affect the financial stability of companies? What are the factors that can mitigate the risks associated with it?"

2. **Research Hypothesis:**

The research is based on the following sequential hypotheses:

a. There is a positive correlation between the level of financial leverage and financial instability in companies.

b. Excessive reliance on debt leads to increased risks of financial distress and liquidity fluctuations.

3. **Research Importance:**

This study addresses one of the most critical issues affecting business sustainability and financial market stability, making it a valuable addition to academic literature. It provides practical solutions for companies to address challenges related to debt management and achieving a balance between maximizing returns and minimizing risks. Furthermore, this research assists policymakers and investors in making informed decisions based on analyzing debt risks and their potential impact on corporate and market stability. Amid financial crises and economic volatility, the study offers effective strategies to enhance financial sustainability, supporting long-term macroeconomic stability.

4. **Research Objectives:**

- Analyze the relationship between financial leverage and financial instability.
- Identify the risks associated with financial leverage.
- Evaluate the role of intermediary factors.
- Propose strategies for managing financial leverage.
- Provide a theoretical and practical framework for decision-makers.
- Contribute to overall financial stability.

5. **Research Methodology:**

The study employs a descriptive analytical method to analyze quantitative data, aiming to identify causal relationships between variables and test the validity of the hypotheses.

6. **Research Scope:**

a. **Spatial Scope:** Baghdad Soft Drinks Company.
b. **Temporal Scope:** The period from 2019 to 2023.

Theoretical Framework – First Section

1. Financial Leverage:

Financial leverage refers to the amount of debt used to finance a company's assets, which varies among firms depending on the need to finance their investment projects (Saeed and Mazloum, 2021: 288). Al-Din Ali (2019: 837) defined it as the reliance of companies on debt in their financial structure, reflecting the ratio of fixed financing costs to the percentage change in variable costs (interest) associated with debt.

2. Importance of Financing:

The importance of financing lies in the following (Al-Sayed, 2006: 64):

1. Covering part of the investment project costs in a timely manner.
2. Ensuring the economic institution's survival amid external constraints, enabling it to compete and achieve better outcomes.
3. Facilitating risk management and organization through central expenses and insurance agents to protect against insolvency and account guarantees.

Additional significance includes:

- Providing liquid and frozen financial resources internally or externally.
- Enabling the completion of existing projects and the initiation of new ones, which boosts national income.
- Supporting the acquisition or replacement of equipment.
- Acting as a quick mechanism for overcoming financial deficits.
- Ensuring liquidity to protect the institution from bankruptcy and liquidation risks.

3. Sources of Financing for Economic Institutions:

a. **Self-Financing (Internal Sources):** (James, 2017: 98)

- Retained earnings.
- Asset depreciation.
- Various reserves.

b. **Debt Financing:**

- Short-term loans (from commercial banks).
- Long-term loans (from financial institutions).

c. **Issuance of Financial Instruments:**
- Common and preferred shares.
- Bonds.

d. **Government Financing:**
- Direct government support.
- Grants and subsidies.

e. **Partnership Financing:**
- Strategic partnership financing.
- Financing through mutual funds.

f. **International Financing:**
- International loans.
- Foreign direct and indirect investments.

4. Disadvantages of Financial Leverage: (Wiley & Sons, 2003: 87)

1. **Increased Financial Risk:**

Leverage increases debt levels, which may lead to insolvency if returns decline.

2. **Magnified Losses:**

While leverage amplifies gains, it also amplifies losses during downturns, potentially exceeding the initial investment.

3. **Liquidity Pressure:**

Regular interest payments from leverage loans can strain cash flows.

4. **Reduced Operational Flexibility:**

Debt obligations limit the ability to pursue strategic decisions like expansion or new projects.

5. **Market Volatility Impact:**

Financial market investments using leverage are highly susceptible to minor price fluctuations.

6. **Higher Capital Costs:**

Elevated debt levels increase future borrowing costs, as lenders view such companies as riskier.

5. Financial Leverage Indicators:

Financial leverage indicators are essential tools for financial analysts to evaluate capital structure and assess the extent to which a company relies on debt for financing operations and assets. These indicators reveal potential financial risks, particularly during revenue disruptions, providing insights into corporate sustainability and the impact of capital structure on profitability and liquidity. Key indicators include (Ross and Jaffe, 2016: 68):

- **Debt-to-Equity Ratio:**

Formula: Debt-to-Equity Ratio = (Total Debt / Total Equity) * 100
Benchmark: Preferably below 1 (100%) for industrial companies.

- Low Ratio (< 1): Indicates reliance on equity for operations, reducing financial risks.
- High Ratio (> 1): Indicates heavy reliance on debt, increasing repayment risks during revenue declines.

- **Debt-to-Assets Ratio:**

Formula: Debt-to-Assets Ratio = (Total Debt / Total Assets) * 100
Benchmark: Preferably below 0.6 (60%) for industrial companies.

  - Low Ratio (< 60%): Indicates reliance on equity or internal revenues for asset financing.
  - High Ratio (> 60%): Indicates significant debt reliance, increasing financial burdens and risks.

- **Interest Coverage Ratio:**

Formula: Interest Coverage Ratio = EBIT / Interest Expenses
Benchmark: Preferably above 3 (coverage at least threefold).

  - High Ratio (> 3): Indicates sufficient earnings to cover interest expenses, reducing financial distress risks.
  - Low Ratio (< 1): Indicates insufficient operational earnings to cover interest expenses, risking default.

- **Long-term Debt to Working Capital Ratio:**

Formula: Long-term Debt to Working Capital Ratio = Long-term Debt / Working Capital
Benchmark: Preferably below 1.5 (150%).

  - Low Ratio (< 1.5): Indicates working capital can sustain long-term debt burdens.
  - High Ratio (> 1.5): Indicates operational liquidity strains due to long-term debt.

- **Financial Leverage Ratio:**

Formula: Financial Leverage Ratio = Total Assets / Equity
Benchmark: Preferably between 1.5 and 2.5 for industrial companies.

  - Low Ratio (< 1.5): Indicates equity reliance, reducing risks but potentially limiting growth.
  - High Ratio (> 2.5): Indicates heavy debt reliance, increasing bankruptcy risks.

Second Section – Financial Stability

1. Concept of Financial Stability:

Financial stability is defined as the condition in which the financial system effectively performs its core functions, such as credit provision, risk management, and payment facilitation, even amid economic challenges or shocks. This includes the stability of financial institutions, markets, and infrastructure (Al-Sabbagh, 2020: 148). Obaid (2021: 41) described it as the financial system's resilience to economic and financial shocks while continuing to provide essential services, ensuring sustainable economic growth and fostering confidence among market participants.

2. Importance of Financial Stability: (Al-Rifai, 2022: 57)

- Enhances confidence in the financial system, attracting investments.
- Supports economic growth by providing necessary project financing.
- Reduces the likelihood of financial crises that could lead to economic and social disruptions.

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3. Concept of Financial Instability: (Hamza, 2021: 33)
Financial instability refers to the inability of the financial system to withstand economic shocks, leading to the failure of its core functions, such as institutional collapse or market crashes, resulting in negative economic repercussions.

4. Causes of Financial Instability:

- Excessive reliance on debt financing.
- Weak regulatory oversight of financial markets.
- Market volatility driven by speculation.
- Major geopolitical or economic crises.
- Proliferation of complex financial instruments that are difficult to manage.

5. Strategies to Prevent Financial Instability: (Abdul Salam, 2020: 63)

1. **Enhanced Financial Supervision:**

Implement strict regulatory frameworks to ensure compliance and reduce risks from financial violations.

2. **Economic Diversification:**

Reduce over-reliance on specific sectors by promoting economic diversification and expanding the local production base.

3. **Risk Management Improvement:**

Establish effective systems for managing financial risks such as credit, liquidity, and market volatility risks.

4. **Increased Market Transparency:**

Provide clear and accessible information to all market participants to limit rumors and speculation.

5. **Creation of Stabilization Funds:**

Develop financial stability reserves to address sudden financial crises through coordinated economic policies.

6. **Integration of Monetary and Fiscal Policies:**

Ensure policy coherence to achieve stability and minimize conflicts between objectives.

7. **International Cooperation:**

Promote collaboration among nations to address global challenges such as economic crises and financial volatility.

Practical Aspect

Based on the theoretical framework presented earlier, specific financial leverage indicators will be applied to demonstrate the relationship between financial leverage and its impact on the financial stability of the research sample.

1. Debt to Equity Ratio

Table (1) illustrates the Debt to Equity Ratio indicator

Year	Total Debt	Property Rights	Debt-to-equity ratio
2019	37350959640	366178176830	0.102 (10.2%)
2020	51865737401	427224980075	0.121 (12.1%)
2021	58684705112	500089669664	0.117 (11.7%)
2022	63061675418	496451521649	0.127 (12.7%)
2023	83665425634	558951780248	0.150 (15.0%)

Source: Iraq Stock Exchange, Baghdad Soft Drinks Company for the years (2019-2023).

Analysis:

1. **Trends:**

The Debt to Equity Ratio showed a gradual increase from 10.2% in 2019 to 15.0% in 2023.

2. **Reasons for the Increase:**

- Total debt increased by more than 124% during the period (from 37.35 billion in 2019 to 83.66 billion in 2023).
- Equity improved, but at a slower pace compared to the rise in debt.

3. **Impact:**

Despite the increase, the ratio remains significantly below the accepted benchmark of 1 (100%), reflecting strong financial stability for the company with limited reliance on debt.

4. **Recommendation:**

It is recommended to monitor the future rise in debt to ensure the ratio remains within safe limits, particularly given the potential for higher borrowing costs if interest rates increase.

2. Debt to Assets Ratio

- **Benchmark Ratio:**

It is preferable for the ratio to be below 0.6 (60%).

Table (2): Debt to Assets Ratio

Year	Total Debt	Total Assets	Debt-to-asset ratio
2019	37350959640	403529136470	0.093 (9.3%)
2020	51865737401	479090717476	0.108 (10.8%)
2021	58684705112	558774374776	0.105 (10.5%)
2022	63061675418	559513197067	0.113 (11.3%)
2023	83665425634	642617205882	0.130 (13.0%)

Source: Iraq Stock Exchange, Baghdad Soft Drinks Company for the years (2019-2023).

Analysis:

1. **Trends:**

The ratio gradually increased from 9.3% in 2019 to 13.0% in 2023.

2. **Reasons for the Increase:**

- The increase in total debt, as mentioned earlier.
- Improvement in total assets, but it wasn't enough to keep up with debt growth, leading to the rise in the ratio.

3. **Impact:**

The ratio remains well below the benchmark ratio of 60%, reflecting the company's ability to manage its assets effectively without excessive reliance on debt.

4. **Recommendation:**

The company may need to further strengthen revenue-generating assets or reduce reliance on debt in the future to avoid the ratio rising further.

5.

3. Interest Coverage Ratio

- **Benchmark Ratio:**

It is preferable for this ratio to be greater than 3.

Table (3) shows the Interest Coverage Ratio

Year	EBIT	Interest Expense	Interest Coverage Ratio
2019	57216669041	200350000	285.6
2020	61158177606	678164041	90.2
2021	60114471157	768047560	78.3
2022	61060682087	95487430	639.3
2023	115370072443	76534098	1507.1

Source: Iraq Stock Exchange, Baghdad Soft Drinks Company for the years (2019-2023).

Analysis:

1. **Ratio Trends:**

○ The ratio saw a significant increase in 2022 and 2023 compared to the previous years.

○ The interest coverage ratio was very high in all years, indicating excellent ability to cover interest costs.

2. **Reasons for the Significant Increase in 2022 and 2023:**

○ A sharp decrease in interest expenses in 2022 and 2023 (from 768 million in 2021 to 76 million in 2023), leading to an unprecedented increase in the ratio.

○ Significant growth in operating profits, especially in 2023, where EBIT exceeded 115 billion.

3. **Impact:**

○ The company is in a very strong financial position regarding its ability to cover interest expenses, which reduces the risk of financial distress.

4. **Recommendation:**

○ It is advised to maintain this level of efficiency in managing debt and interest costs.

4. Financial Leverage Ratio

- **Standard Ratio:**

The preferred range is between 1.5 and 2.5.

Table (4) shows the Financial Leverage Ratio

Year	Total Assets	Total Equity	Leverage Ratio
2019	403529136470	366178176830	1.10
2020	479090717476	427224980075	1.12
2021	558774374776	500089669664	1.12
2022	559513197067	496451521649	1.13
2023	642617205882	558951780248	1.15

Source: Iraq Stock Exchange, Baghdad Soft Drinks Company for the years (2019-2023).

Analysis of the Financial Leverage Ratio:

1. **Trends:**

The ratio has remained relatively stable between 1.10 and 1.15 over the years.

2. **Impact:**

The values are below the lower end of the standard ratio range (1.5), indicating that the company relies more on equity than on assets, which suggests a conservative approach to financing.

3. **Recommendation:**

The company may need to consider utilizing more financial leverage to increase returns on equity.

Conclusions and Recommendations

Conclusions:

1. **Increase in Debt-to-Equity Ratio:**

The data shows a gradual increase in the Debt to Equity ratio for Baghdad Soft Drinks Company from 10.2% in 2019 to 15.0% in 2023. Despite this rise, the ratio remains low compared to the standard benchmark (1 or 100%), indicating solid financial stability and a moderate use of debt.

2. **Increase in Debt to Assets Ratio:**

The ratio rose from 9.3% in 2019 to 13.0% in 2023, with significant growth in total debt compared to assets. However, the ratio remains well below the preferred standard (60%), reflecting the company’s ability to finance its assets in a balanced way without excessive reliance on debt financing.

3. **Significant Improvement in Interest Coverage Ratio:**

The company recorded very high levels in the interest coverage ratio, especially in 2022 and 2023, reflecting a strong ability to meet financial obligations related to interest payments, thereby reducing the risk of financial distress.

4. **Stability in Financial Leverage Ratio:**

The financial leverage ratio remained between 1.10 and 1.15 over the past five years, which is lower than the preferred range (1.5 to 2.5). This indicates that the company relies reasonably on equity financing with limited use of debt to achieve growth.

Recommendations:

1. **Monitor Leverage Ratios:**

It is essential to monitor the increase in financial leverage in the future, especially with the possibility of rising interest rates. Maintaining the ratio within safe limits will ensure sustainable financial stability.

2. **Reduce Dependence on Debt:**

Given the increasing debt levels, the company should focus on strengthening other financing sources (such as equity financing) and reducing reliance on debt to mitigate future financial risks.

3. **Improve Cost Management Efficiency:**

Despite good performance in covering interest, the company should continue to enhance its strategies for managing debt-related costs, focusing on controlling financial expenditures and maintaining liquidity flexibility.

4. **Increase Revenue-Generating Assets:**

To prevent the further rise in the debt to assets ratio, the company should invest in assets that contribute to revenue growth and improve long-term financial stability.

5. **Risk Management Strategies:**

Since reliance on debt carries inherent risks, it is recommended to develop comprehensive strategies for managing financial risks (such as interest rate fluctuations) and enhance contingency capabilities to handle potential crises.

6. **Improve Financial Diversification:**

By diversifying financing sources (such as issuing bonds or strategic partnerships), the company can reduce exposure to market risks and achieve greater financial stability.

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