The Two Sides of Leverage

BROADLY SPEAKING, LEVERAGE IS MEANT TO PROVIDE AN ADVANTAGE. It can enable a company to increase its potential return from a smaller amount of resources or take a larger risk than otherwise possible. If used properly, leverage can help both investors and companies obtain a desirable return on an investment while operating on a sound basis. Leverage uses others' money or resources to magnify the effect of your own. It's how money is made, and it makes growth possible.

However, leverage is usually accompanied by greater risk. If a leveraged investment is made and the investment turns sour,the loss is muchgreater than it would have been if the investment had not been leveraged. It's important to remember that leverage can magnify both gains *and* losses.

Too much leverage risk (over-leverage, inadequate capital, or just too much debt) is a common source of failure. Risk management techniques, including risk avoidance, risk mitigation, and deleverage (holding a greater amount of capital or financial resources), can help (deleveraging is often a forgotten option, as it usually results in increased costs that might be viewed as a cost of insurance against failure). But at the same time, these approaches tend to reduce the opportunity for profit, although the first two are more directly related to the risks undertaken.

Examples of the use of ultimately unsuccessful leverage risk include the relatively thinly capitalized Equitable Life and Northern Rock in the U.K. Often the most significant risk factor for an entity seeking to expand is an overreliance on leverage. So, how can leverage be taken advantage of without chancing doom? Or when is there too much or too little leverage? And when does a risk-taker become a speculator?

Current actuarial thought is that a well-developed strategy has to incorporate a rigorous embedded approach to enterprise risk management. Too great a reliance on leverage without constraint can lead to excessive risk-taking. This is the classic trade-off between risk and reward, magnified in size or scope. The extent of leverage risk that an entity is willing to take on is an important element of corporate strategy. A prudent approach makes use of a sufficient level of capital, margin, or collateral and utilizes regulatory or rating agency cut-off points, keeping speculation within bounds. But even if an entity has effectively embedded risk management techniques in its operation, it still faces systemic or contagion risks that are difficult to avoid because avoiding all risks also reduces opportunities for a desired return.

When used in conjunction with sensitivity and stress tests for both individual risks and aggregations of related risks, leverage ratios can be useful. The degree of leverage risk should be transparently disclosed so stakeholders can make their own determination of the likelihood of achieving desirable objectives. Many multinationals have taken advantage of international diversification and the globalization of capital (at least in most economic situations). It makes sense to construct useful leverage metrics both locally and internationally.

When markets go sour (or risks go bad), leverage magnifies losses. When that happens, financial institutions may have to be bailed out, with the taxpayers picking up the tab (gains privatized and losses socialized). However, the system shouldn't also create an inordinate amount of moral hazard; the assumption that participants will always be bailed out if they are large enough should be contained.

Over the past several years, inappropriate and excessive leverage by individuals has led to disaster when house purchases were financed with no or little down payment, banking on the expectation that the price of the underlying assets (property in this case) would continue to rise. The likelihood of such a leverage strategy succeeding was, to a great extent, a function of timing, depending on where on the housing bubble the risk was taken. Unfortunately, it's difficult to determine where you are on a bubble.

A related example involved the five largest U.S. investment banks that borrowed funds to invest in mortgage-backed securities, continually increasing their leverage between 2003 and 2007 in a seemingly desperate search for greater yields. During September 2008, these firms went bankrupt (Lehman Brothers), were bought out by other banks (Merrill Lynch and Bear Stearns), or were restructured as commercial bank holding companies, subjecting themselves to the leverage restrictions of a commercial bank (Morgan Stanley and Goldman Sachs).

Since fulfillment of an insurer's obligations is in the public interest, some level of regulatory oversight is appropriate. The most common regulatory metric is the required level of risk-related capital. Regulators need to be capable of identifying the point or range at which leverage becomes dangerous to a company (or, on a macro level, to an industry or economy). What's needed in insurance is effective company-based risk-based capital formulas that are evaluated using internal models reflecting both entity-specific and systemic risks and targeting industrywide capital levels with respect to systemic risks.

Based on the experience of the 2008 financial crisis, capital requirements for all financial services firms need to be re-evaluated, especially with respect to systemic and contagion risks. Society doesn't benefit over the long term when leverage-fueled booms occur. Enhanced real-time and early-warning tools are needed, and regulators must have the ability to act when needed. ●

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