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Evolution of Financial Crisis: Cause, Effects and Cantagion

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ABSTRACT

Throughout history, the development of financial crises has been a recurrent and complicated phenomenon. The main elements and phases that contribute to the onset and progression of financial crises are summarised in this abstract. It looks at how economic, governmental, and behavioural factors interact to influence how these crises develop. The conclusion emphasises the significance of proactive measures and efficient risk management in reducing the effects of financial crises and supporting stability in the international financial system. The summary also underlines the essential terms related with financial crises

KEYWORDS

Evolution, Economic Factors, Financial Crisis, Global Financial, Regulatory, Risk Management.

I. INTRODUCTION

The finance of businesses was significantly impacted by the financial market crisis that started in mid-2007. A Minsky moment occurred. However, the legal features of funding and exit transactions are unaffected. Even after the crisis, the same legal procedures and mechanisms that were available before the crisis will be accessible. However, the financial crisis raised peoples risk awareness. Therefore, it is reasonable to predict that risks will be managed more carefully in the immediate aftermath of the crisis before businesses once again become less risk averse and beginresponding to risk as such instead of the fear of negative things happening [1]–[3]. There was a trend towards increasing leverage before to the crisis. It became increasingly challenging for non-financial companies to get debt finance during the crisis. In order to assure liquidity, businesses needed to have a sufficient amount of equity on their balance sheets. Following the crisis, businesses might once more have better access to debt financing. The choice of principal is one factor that could alter the funding mix of businesses after the financial crisis. The choice of shareholders as the most crucial principle in corporate governance contributed to the trend towards increased leverage. However, organizations with management that opt to advance the organizations long-term objectives over the shareholder’s short-term goals are more likely to endure over the long run.

Separation of Investment

Whether investment and funding decisions are independent decisions can be a topic of debate in financial economics, corporate finance law, and business practice V monetary economics. Financial economists distinguish between funding and investment decisions. When a company contemplates purchasing an asset, it should make an estimate of the cash flows that are anticipated to result from asset ownership. Then, these should be discounted at a rate that takes into account the risk attached to those cash flows. If the assets net present value NPV is positive, it should be purchased. Another issue is how the acquisition should be financed.1

The Fisher-Hirshleifer separation theorem, which Irving Fisher initially developed, states that investing and financing decisions can be separated if there is a chance to borrow and lend money. Consequently, finance and investment decisions ought to be made separately. Three significant ramifications of the separation theorem include: The Company should first make investments in initiatives that increase its wealth. Second, because individual owners can maximize their own personal preferences, their personal investment preferences are meaningless when making company investment decisions. Third, the wealth of the owners is unaffected by the financing strategy.

The unanimity proposition, which is a counterpart to the separation theorem, states that businesses do not need to worry about making decisions that balance divergent shareholder interests because all shareholders are assumed to have the same interests and should, therefore, support the same choices [4], [5]. The unanimity proposition is not particularly good at capturing business reality. For instance, actions made by the company may have an effect on the controlling shareholder's interests in ways other than how they will affect the companys value due to the benefits of control. In corporate groups, decision-making in the member companies is typically influenced by the parent companys or the group's overall commercial interests. It was stated in Volume I that shareholders cannot be considered the owners of the company in the first place and that they do not have the same interests.

Without financing, the company cannot buy any assets. A The acquisition and funding are frequently covered by the same contract. Such cases include asset-backed or structured finance simple financing transactions simple purchases of supplies or equipment, and generally large transactions in which the availability of funding is frequently a prerequisite to closing. a The availability of external money can affect the amount that the firm can invest or the price that it can pay, even when the acquisition and funding are not a part of the same contract framework. For instance, whether or not potential lenders think that the assets cash flows would allow the debts to be repaid, or whether the asset may be used as collateral, can affect the availability of debt funding. Thus, the interests of lenders and other investors and the structure of the fundraising transaction may have an impact on how the acquisition is structured.

Generally speaking, by selecting a less capital-intensive business strategy, the company can lower its funding requirements. Using conventional financial transactions like leasing lessen its other external finance requirements. The company can also use sale and repurchase agreements repos to temporarily release capital or decrease its requirement for other external finance by borrowing the securities it requires. Refinancing is a technique that private equity firms have mastered to lower the amount of outside cash required and to restore capital following a successful takeover.

On the other hand, when powerful shareholders have a very short investment horizon and simply want to maximise their own short-term gains without considering the interests of the company, the cost of shareholder's capital might grow. One of the key distinctions between, say, major publicly traded enterprises and family-owned businesses is this. Even the handling of information might be important. Investors could be confused about the reasoning behind the companys choice of funding. Firms do tend to issue shares during good times when share prices are high, but the market may see the issuance of additional shares as an indication of overvaluation. As an alternative, it may be seen as a signal for a lucrative investment opportunity.The issuer can disguise the issuance as one necessitated by a profitable investment decision, such as a takeover, and clearly communicate the investment decision to the equity market in order to persuade investors that the latter is true and cause them to forget what they should know about the rational behavior of issuers.

II. DISCUSSION

Legal Risks Inherent in Funding Transactions

Funding agreements may be complex legally. Their legal features rely on the kind of financing debt, equity, mezzanine, reducing capital requirements, the business structure of the company, the class of investors, the specifics of the transaction, and other factors including the applicable legislation. The kind of financing will determine the legal framework that applies to the fundraising transaction and any relevant agency relationships between the business and its different investors. Funding transactions, however, are often impacted by the same broad legal considerations as investment transactions. This makes sense given that the firms finance transactions may also constitute other party's investments. Cash flow, risk, information, and agency connections are the four elements that the company will govern in both scenarios.

Cash Flow in Funding Transactions

It goes without saying that the company has to control finance availability and pricing. Access to financing, the method of obtaining money, the control of expenses and the method of cost payment, as well as the return of funds, are important cash flow-related funding problems. The structure of the transaction greatly influences the modalities of it. In addition to agreements, tax considerations and the transactions accounting treatment also have an impact on financing costs. For the company, the legal implications of risk in financing transactions and investment transactions are essentially the same. For instance, there is a chance that expenses will rise if the contractual framework does not adequately address them or that the contract will be read against the interests of the company

Funding transactions are characterised by a few legal hazards. The most crucial ones have to do with capital availability and withdrawal investor departure, default, cost, and the capacity of investors to influence business management at the organisation. Thus, the overall danger of not having access to enough funds comes first. Over-reliance on a single institution or source raises this danger. Over-dependence may result from the companys business strategy as in the case of Northern Rock, commercial decisions such as an excessive reliance on one bank, or legal decisions. Contracts for money, for instance, between the company and one source may make it difficult for the company to get funding from other sources. Over-reliance is likely to make other funding-related issues worse.

The departure risk similar to the acceleration risk in loan financing comes in second. The financing source might evaporate for a variety of reasons, forcing the company to return money it has already received. a A shareholder may request the return of the money they have invested and leave the company in accordance with the standard conditions of the investment. b On the other side, departure might sometimes be unexpected and occur sooner than anticipated. The materialization of counterparty commercial risk for further information on counterparty commercial risk, may be the reason of this acceleration. The firm might, for instance, favour long-term investors, but a particular investor may decide to withdraw their money from the investment for a variety of reasons, including those allowed by the terms of the investment contract, the investors own default without the firm's consent, the investors desire to increase liquidity, the investors own insolvency, or other factors.

Acceleration may also result from a broad legal danger materializing. For instance, a change in the legislation can make the fundraising transaction illegitimate. The danger of refinancing exists the company could have to pay more for its finance if a comparable agreement is used to replace the funding arrangement. For instance, in a mortgage transaction, refinancing expenses comprise both the increased interest rate and processing charges. The parameters of the current financing arrangement may be a contributing factor to some of the expenditures. If the company wishes to end the partnership, it could have committed to pay fees and charges. The company can also have committed to pay a prepayment fee or compensate the investor for any losses they have incurred. Investors may interpret any contract conditions or other financing terms in a certain way. A contract term indicates the firms readiness and capacity to abide by it.Additionally, contractual responsibilities for certain disclosures exist. If representations or information covenants are broken, the contract may be in default and subject to cost increases, payment acceleration, or cancellation.

Mandatory legislation may also be the foundation for disclosure responsibilities. For instance, the accounting and tax classification of financing transactions affects those transactions structure in many instances. Issuers must abide by obligatory disclosure laws in capital markets. Agency financial issues the issue of firm insiders taking advantage of outside investors has received a lot of attention in mainstream corporate governance studies. The main sources of agency issues in this situation are the presence of competing interests and the agents risk aversion. Agency costs, for instance, are often incurred by creditors as a result of claim dilution, asset withdrawal, asset substitution, and underinvestment [6]–[8]. Even when the company is seen as the primary and the funders and auxiliary service providers are viewed as its agents, there remain agency issues. Claim dilution investing in other projects may prevent the investor from continuing to fund the firm or increasing the funding Funding Withdrawal it may be difficult or expensive to replace the funding arrangement Investor Substitution the transferability of claims may lessen the investors incentives to act in the firm's interests, and the quality of transferees as investors and Investor Substitution.

Issues with the agencys finances. In popular corporate governance studies, the problem of insiders exploiting outside investors has gotten a lot of attention. Competing interests and the agents risk aversion are the key causes of agency problems in this scenario. For instance, as a consequence of claim dilution, asset withdrawal, asset substitution, and underinvestment, creditors often have to pay agency fees. Agency problems persist even when the corporation is considered as the primary and the funders are viewed as its agents. Claim dilution investing in other projects may prevent the investor from continuing to fund the firm or increasing the funding Funding Withdrawal replacing the funding arrangement may be difficult or expensive Investor Substitution the transferability of claims may lessen the investors incentives to act in the firm's interests, and the quality of transferees as investors and Investor Substitution.

Funding Transactions and Community Law

It takes a lot of effort to learn about how financing transactions are governed in the EU. Numerous legal disciplines either directly or indirectly control funding transactions. There are several levels of law internal, national, international, community, market. The EU lacks a comprehensive and consistent framework of securities legislation, in contrast to the US. The location of the market in a particular Member State may affect the applicable market practice. The only thing these legal principles and procedures have in common is that they provide the legal foundation for how the company does business.

Reduction of External Funding Needs

There are several ways the company may affect how much outside capital it needs. Earnings might be kept by the company. The business is able to control the quantity of working capital it has available as well as its investment in physical and intangible assets. The company cash management can make greater use of its current liquidity. Additionally, financial institutions may affect their capital requirements by controlling their risk exposure if they are subject to minimum capital requirements based on that exposure under a regulatory framework applying the Basel II framework or otherwise. The business will pay less for its funding for the external finance premium if it requires less external financing. Reduced external financing requirements may also lower the firms debt, lower the risk of defaulting on its credit obligations, raise the firms credit rating, and lower the cost of borrowing money.

The Basel II framework, which is applicable to banks and other financial institutions in the EU, adds another mechanism via which the cost of borrowing is affected by the decline in capital requirements. Businesses reduce their need for external capital more often if doing so saves money and benefits the company. There may be a variety of causes for this. First off, the company could already be lean. Second, the company can be uninformed and unprepared financially. Third, the transaction costs can be substantial even if the company was aware of the prospective benefits. Some of the transactions that aid in capital release are pricy and intricate. The firms financing requirements may often be most affected by how capital is managed for investments in physical and intangible assets, thus that topic will be covered first. The management of working capital, handling cash, and the unique situation of financial institutions will be addressed after such inquiries.

Retained Earnings

The primary source of funding is internal financing The basic guideline of a limited liability corporation is that this kind of financing is up to the board's decision. The business decisions made by the company determine whether it turns a profit. The government has no authority to dictate how much money a business should earn or how it should generate money. The boards primary responsibilities at the level of strategic planning include choosing how much value to assign to each stakeholder individually and to the organization as a whole. The board also has a variety of tools to prevent the distribution of assets to shareholders. For instance, the Second Company Law Directives restrictions on payments to shareholders are in force, and the board must approve any decisions on the payment of dividends or share repurchases. Depending on the applicable legislation and the business structure, there may be exceptions to the general norm of board discretion. For instance, the general assembly or a qualified minority might demand that minimum earnings be distributed this regulation may be seen as important to defend noncontrolling minority shareholders against controlling owners or to safeguard shareholders as a whole. Additionally, the general assembly can be granted a limited authority to provide the board with enforceable directives.

Management of Capital Invested in Assets

By selecting a less capital-intensive business strategy, the company may lower its financing requirements. Using conventional financial transactions like leasing or sale and leaseback agreements, the company may lessen its other external finance requirements. The company may also use sale and repurchase agreements repos to temporarily release cash or decrease its requirement for additional external finance by borrowing the securities it needs. Refinancing is a technique that private equity companies have mastered to lower the amount of outside cash required and to return capital after a successful acquisition. This group includes factoring and securitization, and the targets assets serve as a significant source of takeover financing. Sell it but keep using it. Many transactions that lessen the requirement for external financing or free up cash include the sale of assets by the company while yet allowing for their continued usage.

Of course, transactions involving sales and lease-backs fall under this heading. On the other hand, it may be argued that even factoring and the securitization of customer receivables allow the company to free up money while maintaining its most valuable asset, namely the client connections that are the basis of its revenue. Owners of the real estate on which the company operates, owners of rights to intellectual property that the company may use in accordance with a licence agreement, providers of operating leasing services, and network partners whose resources or channels the company uses in its operations are all examples of asset investors. Employees and managers may be thought of as asset investors in a broad sense [9]–[11].

III. CONCLUSION

Financial crises develop over time, and this process is complicated and impacted by a variety of economic, legal, and behavioural variables. To lessen the effects of financial crises and promote stability in the global financial system, it is essential to recognise the warning signals, implement solid risk management procedures, and take proactive steps. For the sake of a robust and sustainable financial ecosystem, stakeholders must maintain their vigilance and work together. Financial contagion occurs at both the international and local levels. At the domestic level, transmission is frequently triggered when a domestic bank or financial intermediary defaults on interbank obligations and sells assets in a fire sale, weakening trust in comparable institutions.

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