Moral Hazard as One of the Main Reasons for the Financial Crisis of 2007

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Abstract

The financial crisis of 2007 was the most difficult challenge the world economy has faced since the "Great Depression". While the Great Depression was mainly caused by problems in the supply and demand chain or factors from the real economy, the financial crisis was caused under the influence of financial innovation and market deregulation or purely financial factors. The main goal of this paper is exploring the basic causes of the crisis through a fundamental historical analysis. A central role in the story is given to the moral hazard which in fact, is a basic factor of the financial crisis. Moral hazard is a behavioral problem and a form of position abuse in order to gain personal benefit while transferring the risk of failure to another party. The research was conducted by explanation of this risk, highlighting its role, by identifying him in a number of historical events that preceded and directly caused the financial crisis. Analyzing all of this emerges an overall conclusion that the crisis was caused under a huge influence of the moral hazard, which means that with better management of this risk, the crisis could have been avoided. This leads to a confirmation of the need for further research on the problem called - moral hazard, and general to the asymmetric information problem. Further knowledge in this field allows us to prevent the occurrence of similar crises. As George Soros said “Once we realize that imperfect understanding is human condition there is no shame in being wrong, only in failing to correct our mistakes”. This is actually one of the main objectives of this labor – to learn from the past in order to prevent similar events in the future.

Keywords: Asymmetric information, Deregulation, Financial derivatives, Mortgage "bubble" recession, Risk management

1. Introduction

The huge level of development in the information and communication technology enables fast transfer of information from one end of the world to another in a split of a second. We can say that today the physical borders between countries are almost gone. It is a fact that globalization allows seamless transmission of all the positive effects generated worldwide. While the transfer of the benefits would be considered useful, it must be noted that the process is not selective, so it transmits both the positive and the negative effects. Economic globalization refers to the increasing economic interdependence of national economies around the world by the rapid growth of cross-border movements of goods, services, technology and capital. Globalization could be seen as a positive or a negative phenomenon, depending on the effect that transfers from one country to another, ie globally.

On the other hand everything in the economy is based on decisions (to invest or not to increase capacity or not; to lay off employees or not). The globalization transmits the effects of the decisions worldwide. So whether we are talking about transmission of a good or bad decision we could characterize the globalization as good or bad.

All this leads to the conclusion that there is a connection between information and decision-making in the economic sphere, and the globalization acts as an amplifier of the created effects. Thus, if information cause adopting positive decisions ie growth, globalization would render that growth global, but if there is a crisis, it would hit the world. The most common problem that affects the quality of information is called asymmetric information. It is a situation where market participants have different information and/or a different amount of information. Asymmetric information, in terms of timing, impact before or after the period in which the decision was made. When the impact is before, we are talking about adverse selection and if the problem occurs after the decision, then there is moral hazard. The best example of the danger resulting from wrong decisions, ie the asymmetric information is the financial crisis of 2007-2008. The complexity of human psychology, shown by desire for profit, success and achieving rapid growth in a short period is strongly pronounced. So, using all its power, the financial world acted to eliminate all obstacles (deregulation) to meet the aforementioned human characteristics. This has created a field where you like it or not, reign moral hazard, where every success is individual, and each fall belongs to the system. Globalisation however, was here to amplify this process and translate it into financial crisis, which further passed into world economic crisis, the worst since the "Great Depression".

The main method used in this paper is the historical analysis. In addition certain qualitative and quantitative methods are used, in order to valorize the historical events. Primary data derived from numerous academic articles, journals, books and the databases of the biggest electronic economical web portals. The conclusions are given on the base of descriptive and inductive-deductive analysis. Using these methods and data to analyze the economic events that preceded the crisis brings to fore the presence of the moral hazard which means that with better management of this risk the crisis could have been avoided.

2. Moral hazard

The moral hazard problem is arising as a result of the asymmetric information. As of the timing, this problem occurs after the transaction is done. There are numerous examples in which we may explain the presence of the moral hazard. As an example we can take the behavior of a person who has insured his car. After the conclusion of the insurance, it can be expected that the person's attention to the vehicle safety will be smaller, simply because he knows that if something happens, the risk will be transferred to the insurance company. In other words, moral hazard demonstrates the will of a certain individual to take risk (high risk), which in normal circumstances He would avoid, simply because He knows that someone else will suffer the negative consequences, if they occur [1]. The recognition of moral hazard is very complicated thing, because of the subjective character it has. Proving the presence of the moral hazard exactly, based on the historical events as examples, can be almost impossible, primarily because there is no confirmation of any person who legally was sanctioned as a result of It. However, understanding the basics of this problem is of great importance, in order to take measures for its reduction.

1.1 The impact of the moral hazard on the banking system

The basis of all banking operations is trust. The emergence of asymmetric information in this sector drastically distorts it, which may result with a bank panic. The bank panic itself is not an irrational event. It is an event that occurs when the public receives information about certain irregularity. The bank run arises from potential problems that banks have, not vice versa, the

problems to arise from the bank runs [2]. Bank panics, as history shows, can be a serious problem for the financial system of a country, but also can cause global instability. For this reason, the regulatory authorities have always tried to control individuals and activities related to financial intermediation. Their fundamental purpose is to protect public funds and the confidence in the financial system [3].
The impact of moral hazard on banking operations can be divided into two parts: (1) the impact on the traditional banking activities, and (2) the impact on the financial innovation.

- Traditional banking activities are based on accepting deposits and approving loans. The moral hazard problem appears after the conclusion of the loan contract in which the bank as a lender is the one that can lose. This means that the bank, its management, and its shareholders are the ones who should take appropriate protective measures. There is a famous quote "if you owe 100 thousand dollars to your bank, you are in big trouble....but if you owe $ 100 million, then your bank is in big trouble" [4]. The appearance and the strength of the moral hazard depend on many variables that the bank can control directly, indirectly or cannot control. Factors that have impact on the moral hazard are: the interest rate, competition and regulation/deregulation. The variation in the values of these indicators can dictate bank's exposure to moral hazard, which also has influence on the other banking risks.
- Joseph Schumpeter said that capitalism thrives on innovation, by introducing new processes and technologies that override the old one [5]. According to this the financial engineering is the pillar for development of the financial system. Through this process new financial instruments are created - called financial derivatives. Financial derivatives, although relatively new phenomenon (dating from 1980), reached values that exceeded the value of their base instruments (end of 2007 the total assets of commercial banks in the US was $11.1 trillion, and the contract value of off-balance sheet derivatives reached $164.8 trillion) [6]. Despite the fact that the financial derivatives flooded the market, they were not subjected to any regulation, for a simple reason that the regulatory authorities believed that derivates are operated only by the large financial institutions, which staff has high quality so regulation would be totally unnecessary. The authorities not only that believed that people working for big financial institutions involved in the trading of derivatives have the expertise and conscientious to act in a manner best for the system, but also were strongly opposed to any attempt to regulate this market. "The regulation of derivatives transactions concluded between professionals themselves is unnecessary," said Alan Greenspan (Chairman of FED 1987-2006), and the attempt to regulate the derivatives market by Brooksley Born, (who at that time was the President of Commodity Futures Trading Commission) ended unsuccessfully, after being contacted by Lawrence Summers, (who at the time was the Secretary of the Treasury) with the words: "*I have 13 bankers in my office and they said if you continue with this, we will create the biggest crisis since World War II*." This directly influenced on the creation of conditions suitable for the emergence of moral hazard. This means that the instruments originally designed to reduce risk, were transformed into a major source of problems such as the moral hazard.

1.2 The moral hazard and the financial crisis 2007

The financial crisis has caused many to question, why rating agencies and regulatory authorities never saw the danger? The banks were holding huge amount of risky financial instruments. Did no one saw the danger? In fact, the crisis was seen by many, but what no one saw was its size. Almost no one could have guessed that it would be a world banking system crisis, which would seriously disrupt the financial system and trigger a global economic crisis. The key to the easiest explanation of this lies in moral hazard. Theoretically, the moral hazard problem should easily be prevented, but in the real world we are talking about an incurable disease of the modern financial world. Why moral hazard is an insoluble enigma of

modern finance? The answer lies in what economists call the principal-agent problem. In large companies today (including financial institutions), we have a separation between ownership and management. Principals engage other people - agents who act as managers and should pursue their behavior in a best way, in favor of principal interests. Unfortunately, almost always, the agents are directly involved in all activities and know more than the principals. It is naturally for humans to care more about themselves, so the agents often care more about their own interests, which may lead to destructive effects. Principal-agent problem is further increased with the increased high of power, something that was characteristic for the financial world before the outbreak of the crisis. This was made possible through the process of deregulation which was conducted under great pressure and lobbying by banks on the regulatory authorities and the political factor. Thus they created large financial institutions that were allowed to make a high concentrated market thoughout the debt-securitization process, generating a huge amount of debt on the way. A financial crisis in its pure form is an exit from bank debt. Such an exit can cause a massive deleveraging of the financial system. It is not the asset side of banks which is the problem but the liability side [2]. This huge financial institutions considered themselves “too big to fail” so they engaged riskier operations knowing that the government security net will have to bail them out if they get confronted with problems. The problem of dealing with “too big to fail” financial institutions is not a new one in financial policy, but the severity of the global economic and financial crisis that started in 2007 has put a spotlight on it like never before [7].
Knowing all that has been mentioned, It is not hard to conclude that the smallest mistake would cause a systemic collapse, and with the real danger of a principal-agent problem, making a mistake was inevitable. In other words this means that the system was able to function as long as the mortgage backed credit debtors were finding a way to pay their installments or as long as the music was playing. The housing market was clearly a huge “bubble” as the prices were in a rapid growth. This was not based on real indicators but on speculations. We are talking about a situation where the price of the assets differs from their fundamental market value [8]. At that time the world economy was in expansion. Economic booms can create their own economic climate, making it very difficult for those operating within the bubble to formulate objective measures of the fair value of assets and therefore the sustainable level of credit [9]. So it was hard for the financial analysts and regulators to imagine that there was a bubble and they were not prepared for the possibility of a crisis. On the other side it was obvious that the debtors could not meet their obligations if the rates change, simply because most of them were not creditworthy.

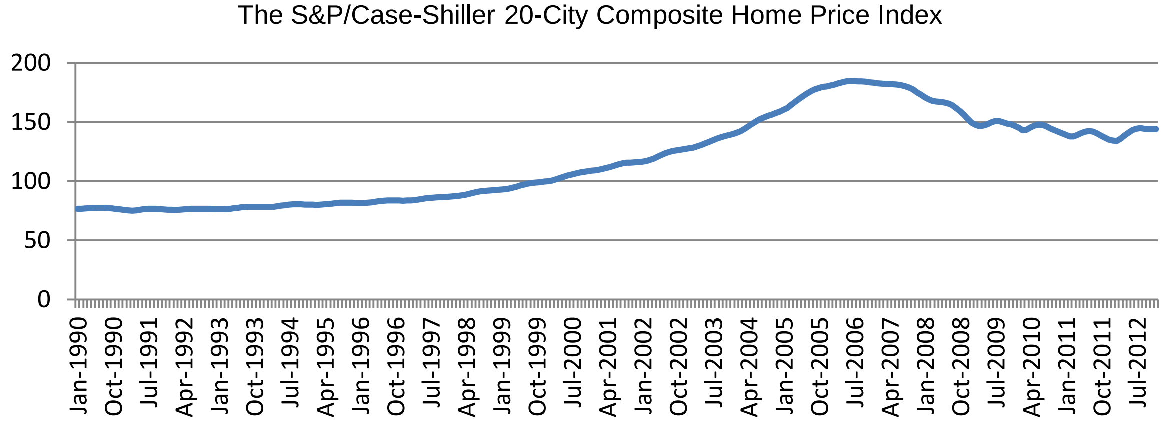

Chart 1 USA Home price Index

The securities based on these mortgage loans were receiving high ratings from the rating agencies (about 60% were AAA). The high ratings can be explained by the fact that the rating agencies main goal is to gain profit so if they don’t meet banks demand and give the wanted ratings, the competition would certainly do. This is just another evidence for the presence of

the moral hazard. As the crisis was beginning to emerge there were a lot of denials by politicians and financial experts which lead to slow reactions that strengthen the crisis. History indicates that the way financial crises are managed and resolved can deeply influence subsequent economic performance. The response can affect the length of the slump, the speed and strength of the subsequent recovery and, it all probability, the long-term growth rate too [10]. All of this lead to a financial meltdown which caused a global economic crises.
Amid highly deregulated system, the bank management can engage operations that are riskier than what a bank should take over. Through the process of securitization (repackaging of loans with generally predictable cash flows into interest-bearing securities with marketable investment characteristics), banks were able to collect additional funds, which were immediately reinvested [11]. Bank debt grew rapidly, but the high profits, blinded the bankers, regulators, and the majority of analysts, financial experts and market gurus. They thought that it was almost impossible for the market to collapse. Some of them were unable to see the crisis even when it started. One of the most infamous statements comes from Donald Luskin, a market guru and a financial analyst, who on September 14, 2008 in The Washington Post said: "Things today just aren't that bad. Sure, there are trouble spots in the economy, as the government takeover of mortgage giants Fannie Mae and Freddie Mac, and jitters about Wall Street firm Lehman Brothers, amply demonstrate. And unemployment figures are up a bit, too. None of this, however, is cause for depression -- or exaggerated Depression comparisons." The next day Lehman Brothers collapsed and the crisis officially begun. When we defined the moral hazard we mentioned that it is a phenomenon which is very easy to be defined in theory, but very difficult to prove in practice. As mentioned, the problem lies in the principal-agent theory. Agents (in our case managers at major banks) were those who abused their position taking huge amount of risk, believing that the institutions are simply too big to fail and in the worst case scenario the shareholders and depositors are those who will lose.

3. Conclusion

“There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know.” - Donald Rumsfeld. This leads to thinking: what are the known knowns, what could be known unknowns and is it possible to assume the unknown unknowns? But what if we are wrong? What if all belongs to the third group? What would be then the cost of our ignorance? Taking into account what we talked through previous pages, we can conclude that we know the importance of information in order to make the right decision, we are aware of the existence of asymmetric information and we know the moral hazard. However, despite our knowledge, we managed to get ourselves in a recession caused exactly by the mentioned phenomena. Is the moral hazard the main cause of the financial crisis is the question that everyone, impatiently would ask? Yes, moral hazard is one of the fundamental causes of the financial crisis. However, the reason for the financial crisis as well is our ignorance about this problem. Also the reason for the financial crisis can be our blindness to realize human greed. As Mahatma Gandhi said ”The world has enough for everyone's need, but not enough for everyone's greed”. This carry us to a conclusion that the cause of the financial crisis is that "we do not know that we do not know" how to manage the moral hazard risk.
The financial crisis devastated the world economy causing millions of people to lose their jobs, homes, savings and some of them their lives. It is clear that the greed of some caused pain to millions. Sadly the moral hazard problem can hardly be legally prosecuted. As a result of this none was conducted so the people who caused the crisis left the “ring” with their pockets full of money. Albert Einstein said “The world will not be destroyed by those who do evil, but by those who watch them without doing anything”. Therefore it is clear that we need to change the rules and implement regulations that will prevent the occurrence of moral hazard. A well tailored government regulation can mitigate the impact of such excesses (bubbles) and is absolutely necessary to protect the public. The crisis was created by humans, and what is

created by humans can be only changed by humans. So a final conclusion is that further study is needed on this issue. Only thus we could learn a lesson from the past and prevent a similar situation in the future.

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