Intenational finance

Q2. Many experts argue that when the government bails out a private financial it creates a problem called ‘ moral hazard’, meaning that if the institution knows it will be saved, it actually has an incentive to take on more risk, not less. What do you think? A moral hazard exists when one party has a responsibility to advance the interests of another, but has an incentive to pursue his or her own interests first (Dowd, 2009), and the pursuit of one compromises the other. Moral hazards are pervasive in business where one party (i. e. management) is tasked to handle the resources of another (i. e, the investor). In financial undertakings, the existence of moral hazard comes in many forms, such as where management pays itself excessive compensation out of the funds it manages on behalf of its investor, or where it makes decisions to take on risks that the other has to bear. Where interests of management and investor are not aligned, then there is a potential for moral hazard. From its very definition, moral hazards are inevitable; the key is to keep them under reasonable control, which is the major objective of institutional design. The link between risk-taking and moral hazards runs according to this rationale: if I am faced with the option to take risks that may be potentially rewarding for us both, but you bear the burden of the risk, then I have the incentive to take them. However, if I were to bear the potential loss, then I will act more responsibly and cautiously (Dowd, 2009). The moral hazard lies in taking the risk for which another has to bear the consequence. The recent subprime crisis was replete with instances of moral hazards gone uncontrolled. One was the creation of mortgages to subprime borrowers who had little or no capacity to repay the loan (Brummer, 2008), and then selling this loan to Fannie Mae (the Federal National Mortgage Association) which then securitizes the risk and sells it out

as mortgage backed securities (MBS). The quasi-governmental natureof Fannie Mae led to the general understanding that whatever the risk to Fannie Mae and its twin institution Freddie Mac (Federal Home Loan Mortgage Corporation) would be absorbed by the U. S. Treasury, thereby eliminating any risk to the financial institution (Yoon, 2009). The perceived ability to pass on default risks through securitization and increased competition among lenders paved the way for financial institutions to resort to " innovative mortgage option" such as interest only and negative amortization. These " allowed buyers to purchase houses for which they could not sustain the mortgage payments in equilibrium," and caused a deterioration of lending standards (Zingales, 2008). Moral hazards also crippled the validity of assessments by credit rating agencies such as Fitch, Moody's, and Standard and Poor's (S&P), which rated the questionable " innovative" securities as investment grade, in return for which they were paid handsome fees by the very financial institutions that issued these securities. When government bails out a " too large to fail" financial institution, it practically insures this institution against failure. Moral hazard already pervasive in the industry is therefore greatly enhanced, as evidence of this tendency may be deduced from the years leading to the crisis. Therefore, any bailout must be supported by sufficient institutional safeguards, which at present is highly suspect given the weakness of the credit rating agencies. Even now, Congress is faced with an inflated budget deficit which will have to be shouldered by taxes (Parkinson, 2011) – an indication that the American public is carrying the burden of the bailout plan. Until evidence proves the host of good intentions expressed by financial institutions so far, the allure of short-term profit to the negation of long-term

risk will continue to fuel moral hazards in the financial system. References

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