

Good critical thinking on finance online discussion

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Moral hazards refer to a situation where a party to the bank takes risks without necessarily facing consequences for their actions. It is important for the banking system to insure itself against risks that comes with moral hazards. Unless the bank takes regulatory measures to deal with moral hazards, high risk taking can lead to huge losses that can lead to the failure of the institution (Lewis, 2014). As witnessed in the case of Barings PLC, excessive risks such as futile bet against future stock prices would lead make the bank bankrupt if the bet becomes unfavorable. The bank can insure against these moral hazards by using safety net for the financial system such as setting the limit of amount that individual creditors or depositors should be given or allowed to deposit. The bank may also implement risk-adjusted or differential premium systems where necessary and by making timely resolution and intervention before the expected loss can be realized. For example, if Societe Generale had set the limit of amount that Jerome Kerviel could be allowed to take, the bank could not have made a loss of 4.9 billion Euros. Secondly, timely monitoring and intervention could also have played a critical role in saving the bank from the loss.

Deposit insurers can help banks to deal with moral hazards by encouraging and promoting incentives for the banks and their customers such as good corporate governance, effective regulatory and market disciplines among others. One of the major causes of 2008/2009 financial crises is that many deposit insurers failed to discipline banks especially in the matters of regulating their borrowers. It is therefore important for banks to insure themselves against moral hazards since failure to do so can have serious implications to their stability.

References

Lewis, M.(2014). How Not To Lose Your Soul: A Handy Guide for Young Bankers. Bloomberg Businessweek, 4396, 16-17. Retrieved on Nov 18, 2014 from: <http://eds.b.ebscohost.com/eds/pdfviewer/pdfviewer?sid=06c69317-d239-4d56-83d9-825fd24574b5%40sessionmgr198&vid=6&hid=119>