Moral hazard and the financial crisis by kelvin dowd

Finance

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The author defines a moral hazard as a case where a person is responsible for another's interests but puts his or her interests first. He matches this with the CEOs who put their interests first but are responsible for the interests of the taxpayers. The CEOs give themselves excessive bonuses out of the funds they manage.

The subprime scandal is one case he cites where he addresses how banks issued mortgages with the aim of holding them to maturity. It became a disaster and a contributing factor to the financial crisis because the banks used to make losses due to defaulting on the mortgages. More so, the banks used to sell the mortgages to other parties without considering whether they will default or not, as they were only interested in the initial payments received (Kelvin, 2009). The subprime was, as such, agreed game dubbed as " privatizing gains and socializing losses." He, however, does not blame the CEOs only but also cites the failure of financial risk management. He says that the assumptions made in risk management were not viable, for instance, assuming that financial risks follow the Gaussian distribution, assumptions involving market liquidity and so forth. More so, there were modeling errors in risk models that focused too much on the normal market conditions.

The article has content relating to risk management and gives several examples of scandals and disasters happening to particular companies, and most of them leading to financial losses. The financial crisis is the basis for all of them. Several concepts of risk management are applied in the cases

provided. Some of the corporations mentioned made some deliberate efforts to counter the losses and took other measures to recover from the economic shock. Thus, there is risk response and recovery. Response is where the organization counters the disaster, and recovery is the restoration to the previous position. The responses to the economic shock that took place were by the governments. The government (US) took some measures like investing in various areas to create employment forcefully and reducing taxes. For companies, they reduced debt financing. The recovery took place in the corporations by forcing the taxpayers to cater for the loss.

There were some community recovery planning that was applied, and it included identifying the most vulnerable societies and offering financial support (Kelvin, 2009). The economic conditions were affected since private investment reduced, which reduced the supply of goods. In the cases discussed by Kelvin, there is not the mention of any FEMA, NRF or NIMS involved. Other recovery methods that could be used would be to reduce the pay packages for the CEOs and putting in place strategies for the remuneration of the CEOs.