

FOR DISCUSSION...



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## Moral Hazard and the Mounting of a Crisis: A U.S. Narrative

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## *For discussion...*

From a historical perspective, as moral hazard was mounting, the Fed deployed a new doctrine, deregulating to surmount the so-called challenges of globalization, while financial innovation was on the rise. This paper focuses on another aspect of the crisis: moral hazard. If a firm or even a system is said to be too big or interconnected to be allowed to fail, then surely there is something that could and should be learned. In Industrial Organization and more particularly in contract theory, these dynamics are captured by the concept of moral hazard.

Although moral hazard may not be the sole cause of the rise of systemic risk within what makes the financial and banking industries, it should be evident that it contributed to the level of systemic risk.



**I**n the aftermath of the Asian crisis, some scholars highlighted the need to check the level of moral hazard inherent in rescued financial institutions, fearing that it could lead to increased risk-taking on their part and to greater systemic risk overall (Pomerleano 1998; Radelet and Sachs 1998). To be sure, the problem had been in evidence well before then. It has been a concern ever since the rise of the notion that the central bank should be a Lender-of-Last-Resort in a financial crisis. Indeed, it was the primary reason why Walter Bagehot insisted that the central bank advance funds only on quality assets and set the interest on its emergency infusion of liquidity at “a penalty rate.” But, the question remains for many, why should any bank be extended such protection?

The point, to be clear, is not to save any particular bank and certainly not to save any particular banker. Rather, it is to protect a nation’s payments and clearing systems. This is important because virtually everything that occurs in an economy that uses money or credit depends upon these networks. Moreover, the reasons that the authorities are inclined to designate, explicitly or implicitly, some prominent financial institutions as Too big to Fail (TBTF) is that they generally do not have time or capacity, once the crisis hits, to puzzle through the panic and the fog induced by a

lack of information. Having to move quickly, and wishing to err on the side of caution, the best course is to act decisively to end the crisis first, while committing oneself to work out the details of a more managed resolution at some later time, when the turmoil has passed, and calm has been restored. These decisions have to take place in a hurried and even panicked atmosphere because financial expectations and credit are generally more fickle and mobile than patronage in other markets and for this reason impose a substantially shorter time frame for analysis and action than, say, the markets for automobiles, toys, or even labor.

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***The FDIC's insurance fund is only designed to handle the level of bankruptcy that occurs in more-or-less normal times.***

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A complicating factor is that in the United States, state and federally-chartered banks offer customers deposit accounts backed by insurance that is, in turn, guaranteed by the Federal Deposit Insurance Commission (FDIC) and ultimately the United States Treasury. Less well understood is that insured banks are charged a small fee, based on the size of their balances and other considerations, in exchange for this insurance. While the federal government is the ultimate guarantor that this insurance fund will never be insolvent, the fact is that at any given instance the FDIC's insurance fund is designed to handle only the level of bankruptcy that occurs in more-or-less normal times. Thus, it is inadequate to cover a system-wide crisis. For example, a predecessor agency in charge of the insuring the Savings & Loan sector, the Federal Savings and Loan Insurance Corporation (FSLIC), had to be rescued with a special dispensation of funds from Congress. However, when the FSLIC initially ran into trouble in the 1980s, the President and the Congress were reluctant to authorize this disbursement. One reason was that doing so invites a public discussion over why the system became insolvent and who or what might be responsible. A second was aggressive lobbying by the industry as it understood that a replenishment of funds meant the shutting down of insolvent institutions.



Lacking adequate funds to wind down the positions of the largest failed banking institutions, the administrators of the insurance fund are forced to pursue “second best” strategies. The first and most obvious of these strategies is *forbearance* on taking over and resolving one or more large insolvent institutions. This is typically accomplished through an imaginative change in accounting rules to allow troubled banks to list non-performing loans on their books as worth their original, as opposed to their estimated market or resale, value. With such modifications in place, the bank will *appear* to be fully capitalized, when in fact it is not. The effect is that the institution can stay open and even continue to make loans.

The goal of this short paper is not to provide a comprehensive analysis of all the intricacies of the financial crisis - we acknowledge this is impossible - but rather to highlight one aspect of it: the moral hazard behavior. If a firm or system is said to be too big and thus cannot be allowed to fail, then surely there is something in the dynamics that could and should be learned and perhaps modified. Ideally, whatever is learned would be of use in changing the system so as to prevent future failures and crises. It is in this spirit that we are proposing a partial analysis based on the assumption that a big issue of the current crisis was the feeling that the system could not collapse, meaning that the U.S. government could not and would not let it collapse. In Industrial Organization and more particularly in contract theory, these dynamics are captured by the concept of moral hazard.

Moral hazard may not be the sole origin of systemic risk in the financial and banking industries (Prasch 2010). Systemic risk may well be intrinsic to the nature of the financial sector, but even beyond this, moral hazard may leverage or amplify any given level of systemic risk. So the question is what led to a rise in the systemic risk in the U.S.? We need to draw an analysis in differences, in other words, we need to estimate the new level of risk exposure compared to the initial state. And the initial state in the U.S. was

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***The initial state in  
the U.S. was the  
extended reign of  
the Glass-Steagall  
Act of 1933.***

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the extended reign of the Glass-Steagall Act of 1933. Briefly stated, this act prevented the creation of universal banks. In the late 1990s, based on extensive industry lobbying in addition to changes in economic and political doctrines of the 1980s and 1990s, it was repealed. These changes in economic and political doctrines are possible explanations for a rise in the level of systemic risk of the U.S. financial and banking industries. As a report issued by the Fed in 2001, the larger banks that emerged were more opaque and less transparent than before. The same report indicated that there was little if any evidence of efficiency gains (Ferguson Jr 2002).

In the next sections, we will return to the 1990s era and look at the change in the Fed's doctrine towards the notion of systemic risk, then we will go back to the 2000s and analyze how the new definition of systemic risk translates into the Too Big to Fail doctrine. We will then highlight the U.S. political changes from the 1980s to the 2000s supporting the regulatory and players' perception changes. We will then explore some options that may help to prevent a future crisis.

## The 1990s: the Fed and the notion of systemic risk

**D**efining the concept of systemic crisis is not an easy task. One could characterize it as a situation where a crisis in the financial sector has a large-scale impact on the real economy (Lamfalussy 2003). Compounding the difficulty of defining systemic risk is that it may not be easy to apprehend what generates a risky situation. Balderston shows that from the market structure to the liquidity issue through the question of regulations, financial stability is a fragile equilibrium (Balderston 1966).

More recently, the practice of securitization and the associated leveraging are closely associated one with the 2008 financial crisis. Securitized products such as collateralized debt obligations (CDO) are particularly vulnerable to systematic risk while embodying higher tail risk (Fujii 2010). In turn, this created some endogeneity and led to a higher systemic risk. To achieve greater stability of the financial system and avoid a higher degree of systemic risk, macroprudential regulations should have been implemented (Fujii 2010). Sadly, just the opposite occurred under Basel II. The ideology of efficient markets was fully in charge (Prasch 2011a).

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***Circumstances, including overt legislation such as Dodd-Frank, have now forced the authorities at the Fed and its sister agencies in Europe to become increasingly concerned with financial stability.***

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Deregulation (and in an even more important sense the de-supervision) of financial markets began during the late 1970s and early 1980s. The record, from the S&L crisis to the current crisis and related events in Iceland, Ireland, and Greece, are now evident for all to see. Circumstances, including overt legislation such as Dodd-Frank, have now forced the authorities at the Fed and its sister agencies in Europe to become increasingly concerned with financial stability. To summarize, with the rise of systemically important bank and non-bank financial institutions, the Fed has been obliged to take an increased interest in the overall stability of the system, although they have pointedly done so only after significant problems emerged.

For instance in 1998, one of the most celebrated and admired of these new financial institutions, Long-Term Capital Management (LTCM), landed in serious difficulties (Lowenstein 2000). Through a variety of operations in the derivatives markets, it had placed a substantial bet on the convergence of bond prices across the EU as the date of the Euro's introduction drew closer. In the wake of Russia's default on its sovereign debt, their bets proved to be catastrophically wrong. LTCM was losing money, and doing so at an alarming rate. Moreover, because they had borrowed heavily from a number of sizable commercial and investment banks, its imminent failure promised to put a hole in the balance sheets of these latter institutions, some of which were federally-insured and, at least formally, supervised and regulated by the Fed. The consequence, many insiders worried, could be a financial panic. This panic would bode poorly for the stewardship of the Fed, its *laissez faire* ideology of the time, and the emerging "shadow banking system." Something had to be done to protect all three, but what could it be?

The Fed's answer was to organize a privately-financed "bail-in" of LTCM. Happily, they were able to get virtually unanimous consent on this policy

from 20 or so major banks. The only hold-out was the investment bank Bear Stearns. The latter claimed, with some cause, that as the bank most responsible for clearing LTCM's trades, they were already over-exposed (Cohan 2009). This rescue "worked" in the sense that the meltdown was contained. That is to say that the major banks were themselves unharmed by the episode, although they did have to tie up a non-trivial portion of their balance sheets with LTCM's assets, at least until they could mature.

## SECOND PART

# The 2000s: From systemic risk to Too Big to Fail

A casual reader of the business news might be forgiven for thinking that the Too Big to Fail (TBTF) doctrine suddenly emerged in the wake of the year 2008. But this is far from being the case. It has been discussed for some years. As discussed, the problem briefly broke into public consciousness as we saw previously when LTCM required a Federal Reserve managed rescue in 1998 (Dowd 1999; Lowenstein 2000). How, it was briefly asked, did such a seemingly obscure firm come to be so central to so many markets? Some asked, what could be done to prevent a recurrence of such a situation? Curiously, it appears that the answer to both of these questions was to enact policies that promised to accelerate and accentuate the same problems that allowed LTCM to become TBTF – a firm that, let us recall, was allegedly managed by the very best that Wall Street and academe had to offer. Deregulation, de-supervision, and over-concentration of a few firms in the markets for many prominent derivatives seemed to be the unimpeachable ideology of the time. The Fed, the Clinton Administration, and the Congress worked to pass the Commodity Futures Modernization Act of 2000 that explicitly forbade the Commodity Futures Trading Corporation and the several state insurance regulators from checking or reigning in CDS or related derivatives.

Another lesson that should have been learned from the several interlinked financial crises that swept the world in 1997 and 1998 came from an

implosion within a new but rapidly growing market – that of securitized subprime mortgages. Most of that market’s largest players went bankrupt at that time (Muolo and Padilla 2010). Finally, we must consider the role of leverage and that its overuse in the 2000s was strikingly parallel to the levels that so greatly contributed to the downfall of LTCM in 1998 (Nocera 2009; Salmon 2009).

Moreover, the assumption that the financial sector benefits from economies of scale reinforced the motivation to become bigger, and ostensibly stronger. Bank mergers have not simply been tolerated by policy-makers over these past several decades. On the contrary, they became an important component of the nation's policy agenda. Such mergers were especially promoted by the Federal Reserve System in the 1990s, before the repeal of the Glass-Steagall Act. But the Fed was also aware that the substantially larger "universal" banks that resulted from these mergers could be more opaque, and for that reason were inherently more complicated from a regulatory perspective. Indeed, in a prescient article, the then Vice-Chair of the Federal Reserve System introduced a major G-10 study of the economics of bank mergers that, while generally laudatory of the remarkable 1980s and 1990s drive to merge banks within the United States, admitted that these consolidations may have contributed to the fragility of the financial of the now-larger firms and to the system as a whole:

“In part because the net impact of consolidation on individual firm risk is unclear, the net impact of consolidation on systemic risk is also uncertain. However, as I noted consolidation clearly has encouraged the creation of a number of large and increasingly complex financial institutions. Our study suggests that if such an institution became seriously distressed, consolidation and any attendant complexity might increase the chance that winding down the organization would be difficult or disorderly” (Ferguson Jr 2002).

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Beyond the issue of opacity, questions remained concerning the relationship between the creation of bigger banks and the rise of moral hazard, and thereby an increase in the level of systemic risk. To provide more context and therefore stress the relevancy of this question, we should also remember that some authors question the definition of systemic risk challenging the often-cited risk of contagion or cascade effects.



## 1982-2012: A new equilibrium on the U.S. political spectrum

Changes in banking practices and regulation were supported by simultaneous changes in political doctrines. Regulations are often the result of negotiations between and among leading parties, although analyses of the financial sector should have been based on a more robust economic analysis. But political doctrines also changed in the 1980s. On the one hand, given their historical posture and prior commitments, one might have expected the Republican Party to be highly attuned to the debate on the future of the U.S. financial market and for that reason inclined to lean on the side of big banks. On the other hand, it is a common place of American history that the twentieth century Democratic Party is the party of President Franklin Delano Roosevelt and “the little guy”. It can lay claim to the Glass-Steagall Act, the founding of the SEC, CRTC, and FDIC, and to unbending oversight in the form of previous leaders of the House Financial Services Committee including Wright Patman and Henry B. Gonzalez. In short, this was a party that for much of the last century stood firmly on the side of regulating the financial and banking industries.

But a change happened in the Democratic Party's posture vis-à-vis the financial sector, starting with a leading figure: Tony Coello (D-Fresno) who initially came to the attention of the public while managing the DCCC from 1981 to 1986. His core idea was to found a new political coalition, one that would go under the banner of the “New Democrats.” In this vision the

Democratic Party would revisit and reconfigure its historic coalition of the white working class, women, and minority voters. In its stead it would appeal to financial elites, women, and (to a substantially less extent than previously) minority and working class voters. This strategy was heralded by the party leadership when Bill Clinton captured 43% of the presidential vote in 1992. This “historic victory” was attributed to Clinton’s “pragmatic” embrace of an economic agenda that was strikingly at variance with the long-time positions of the Democratic Party. Clinton responded to the confidence placed in him by this New Democratic constituency with an ambitious legislative agenda. From a financial perspective, highlights of this agenda included the Riegle-Neal Act (allowing for Interstate Branching and Banking), NAFTA, the Financial Services Modernization Act of 1999 (repealing Glass-Steagall), passage of the WTO, and the Commodity Futures Deregulation Act of 2000, to cite a few.

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Political rhetoric aside, his senior appointments made it almost immediately apparent that Barak Obama intended to work within the framework set previously by the Clinton Administration. For example, the new administration moved almost immediately, in conjunction with a Democratic-majority Congress, to press the Financial Accounting Standards board (FASB) to allow banks to account for many loans on a "historical cost" rather than "mark-to-market" basis. The banks had previously exhibited a strong preference for the latter when real estate prices, and the assets supported by them, were rising. Such accounting rules allowed profits to be booked at the moment that a loan was made. By contrast, “historic cost” accounting values a loan according to what it was worth at the time it was made, as opposed to what it will get at any given moment in a secondary market. Since so many real estate backed Collateralized Debt Obligations (CDOs) were by then worth substantially less in secondary markets (assuming any buyers could be found), these revised accounting standards substantially papered over the enormous losses remaining on

the books of major banks. Under the new rules, these losses did not have to be charged against a bank's capital, which meant that they did not have to borrow more from either the Fed (which, in law, is not allowed to extend loans against anything but quality collateral), the private Repo markets (which are not lending anyway as they understood the value of these assets), or the Troubled-Asset Relief Program (TARP), which was politically poison in the United States. With the large banks so enthusiastic for the change, it was unsurprising that a bi-partisan consensus emerged in favor of these modified accounting practices (Prasch 2011c).

## Some options to explore to prevent a future crisis

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In light of the 2008 crisis, it is legitimate to consider the extent of the TBTF doctrine's addition to moral hazard and systemic risk. Or, to put it bluntly, is Too Big To Fail also Too Big to Succeed? Would smaller institutions with guaranteed deposits, but not designated TBTF, and a generally smaller financial sector, be a win-win deal for the public and the U.S.? Perhaps this is an instance where there is no "trade off" between size and economic efficiency. Such reductions could induce a more stable and more efficient financial system if one considers the total (rather than just marginal) cost of making any individual loan or transaction. As is now clear, adding in the cost of bailouts and sundry charges on the public expenses, makes operating the system as it existed from 1994-2006 prohibitively expensive. Ideally fewer institutions should be able to claim that they are indispensable when the next crisis occurs. Despite the Dodd-Frank Act (2010), much remains to be done if TBTF is to become a relic of the past (Prasch 2011b). In what follows, considering that our perspective here (only) highlights the issue of moral hazard, we offer several proposals to reduce its role and any systemic failure it might induce.

### **(A) Enforce the Law**

While it is true that much deregulation has occurred over these past few decades, the U.S. remains a nation of laws and there are plenty of laws pertaining to banking and lending practices that are still on the books. Unfortunately, the problem of deregulation has been greatly exacerbated

by a policy of de-supervision, and this failure to supervise is common knowledge throughout the industry. For example, in 2004 the F.B.I. released a report demonstrating that rampant fraud existed in the mortgage industry. The report also claimed that 80% of this fraud was materially assisted, if not actually initiated, by the lender. The worst of the problem was – not surprisingly – concentrated in low-documentation and no-documentation originations, which soared in 2005 and 2006. Nothing was done. We have not even mentioned the recent controversy over “robo-signing” during foreclosures or the sloppy paper-trail and widespread tax avoidance associated with MERS. Consider also the following result from the National Appraisers Survey, which revealed that by late 2003:

“Nearly 75 percent of licensed appraisers interviewed as part of the ongoing National Appraisal Survey said they had felt pressure from a mortgage broker in the past year ‘to hit a certain value.’ Fifty-nine percent reported similar pressure from a loan officer working for a lending institution or mortgage company. Fifty-six percent said they had been pressured by a real estate agent, and 22 percent by a third-party ‘appraisal management company’ that provides local appraisal services on contract to national lenders” (Harney 2003; Haviv 2004).

As we contemplate these findings, let us recall that there was and remains no legitimate reason why an honest bank loan officer would ever wish to have an overestimation of the value of the real estate that is the collateral of a loan. Indeed, the only reason to seek out a higher appraisal would be to inflate the loan-to-value ratio and thereby the “points” assessed on a loan. This, in turn, would bolster the annual bonus to be awarded to the mortgage broker or bank loan officer who originated it. Stated simply, over-appraisal is a strategy pursued exclusively by individuals wishing to defraud the bank for whom they are working. In such a scenario the

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***“Nearly 75 percent of licensed appraisers interviewed as part of the ongoing National Appraisal Survey said they had felt pressure from a mortgage broker in the past year ‘to hit a certain value.’”***

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borrowers, and their capacity to repay, are a secondary concern, if they are a concern at all.

Each of the trends mentioned above should have raised alarms among regulators. This is especially the case as they emerged even as thoughtful analysts began to detect a significant rise in real estate prices consistent with a bubble, one that would continue to grow for another three years.

### **(B) Prompt Correction Action**

Many lessons were learned about banks, bank regulation, and bank malfeasance by the time the S&L debacle was cleaned up in the early 1990s. One of the most important was that it is almost always a mistake to allow an insolvent financial institution to continue to operate with government guaranteed funds. In virtually every instance the government's losses were substantially greater than otherwise. The lesson, then, was that insolvent firms should be taken over and resolved as quickly as possible. Knowing this, Prompt Corrective Action (PCA) became the law of the land in 1991. It was part of an effort to mitigate future government losses in the event that other banks got into difficulties. The law mandates (it does not suggest), that in the event that losses significantly impair a bank it is to be resolved right away, before the problem can grow. PCA effectively denies bank regulators or politicians the forbearance option that so dramatically facilitated fraud and enhanced government losses from the S&L crisis (Kane and Yu 1996; Black 2010).

As a matter of practice, the United States government in general and the FDIC in particular have had a lot of experience in closing failed banking institutions. It generally involves firing senior management, stripping off the bad loans, checking the books for any malfeasance or fraud that may have contributed to or even caused the failure, and then selling off the bank to another institution or shutting it down altogether. Since the

current bank crisis began 140 banks were closed in 2009, 157 in 2010, and 92 in 2011.

Again, having learned at substantial taxpayer expense that regulatory forbearance is a poor idea for a bank that is on the ropes, the Congress vowed “never again.” Since 1991 the law demands “prompt corrective action” in the event that a bank is insolvent. The law was specifically not written to convey that the decision is one of “multiple choice” or that the rule is exhortatory. Yet, in the current crisis, we find that some banks are considered too big to be subject to the law.

### **(C) Improved regulations and better supervision**

Joseph Stiglitz proposes a dynamic portfolio approach to prevent moral hazard while tackling the consequences of a crisis (Stiglitz, 2011). On top of this argument, in particular in the context of emerging countries, establishing a new financial framework may help trigger economic growth (Prasad 2010).

Regulation and what makes it more or less efficient has been largely lost in the recent discussion. Rather, what is emphasized is the complexity of modern financial institutions and the system as a whole. However, it should be understood that when we consider bank regulation we face a choice: We could have either more complex regulation or simpler regulated institutions. Given the political and information obstacles inhibiting the former, the latter approach merits more attention. Several options exist for making regulated financial institutions simpler. For example, the “Volker Rule” is a start, as would the revival of anti-trust action. Given the well-known inefficiencies of these behemoth institutions, there really are no compelling economic reasons not to pursue the latter course (Prasch 2012).

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On top of de-regulation, authorities also pursued de-supervision, along with what has been essentially a de-criminalization of rules violations. There are rules about fiduciary duties to shareholders, and rules about “representations and warrants” that one makes when selling complex securities to customers, and rules about integrity in lending standards on mortgages, etc. But it had been some time since these have been properly enforced. The financial system is truly complex. But this complexity does not constitute an excuse for inaction or simple dereliction of duty.

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***A positive externality of such a regulation, especially if the level of capital required increased more than proportionately with the size of bank, would be to prevent banks from becoming too big.***

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A simple and immediate way to separate private risk from social risk (the systemic risk) would be to substantially increase capital requirements. While it would not be a panacea, it would be a step in the right direction. Under the current political regime, it might also serve as a useful reminder that regulations do exist and must be followed. A positive externality of such a regulation, especially if the level of capital required increased more than proportionately with the size of bank, would be to prevent banks from becoming too big.



In this paper, we wanted to highlight the multiple events in the recent U.S. financial history that led to the 2008 crisis. It seems like the crisis came as an incredible surprise to the bankers. The model (ideology?) of an unlimited expansion of the financial sector, as it appeared in the 2000s, came to an end in the most abrupt collapse seen since 1929. Previously, anyone who even mentions the possibility that the financial markets were surfing on a giant bubble was ignored or dismissed, thereby sharing the fate of Cassandra.

The goal of this paper was to focus on moral hazard. From a historical perspective, at the same time as moral hazard was mounting, the Fed followed a new doctrine, de-regulated the financial sector in the hope that it would then be better prepared to surmount the so-called challenges of globalization, while financial innovation was on the rise. All these changes happening at the same time dramatically changed the U.S. financial landscape. Too big and too fast, they resulted in a situation that effectively forced the government to bail out the too big to fail institutions that should not have been created in the first place. From too big to fail to too big to succeed, the meaning and result became the same.

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