

Is Moral Hazard Always Immoral?

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The fundamental questions about the moral hazard

“Moral conduct is the oil of the social machinery. It reduces the inevitable frictions and pushes the social life ahead, without spoiling the social machine,” said Witwicki (1957), the 20th century Polish philosopher. Half a century later, the course of social life was severely disrupted by the global financial crisis, the causes of which have been primarily attributed to so-called moral hazard, or “a temptation to abuse” in Polish literature discussing the crisis.. The concept, apparently demonstrating associations with the abuse in the banking sector, carries strongly negative connotations, and any action linked to moral hazard is seen as unquestionably immoral. No

wonder that today’s academic, business or political discussion increasingly addresses the methods of combating this main antagonist of the global downturn; which, as a kind of modern Pandora’s box, has paved the way for shady practices and defective mechanisms to penetrate the global financial market.

It seems, however, that in the heat of a discussion on how to deal with moral hazard, certain fundamental questions are overlooked which should be taken as a starting point for any further debate. What does moral hazard actually mean? Whom does it concern? Does the government have a moral obligation to extend aid to banking institutions? Or does the bank have a moral obligation to avoid risk so that no government help will be needed? And finally, can moral hazard be eradicated

IS MORAL HAZARD ALWAYS IMMORAL?

La crise financière peut être abordée en tant que perturbation ou rupture du bon fonctionnement de la machine sociale. Comme d'habitude dans de telles situations, l'opinion publique pointe son index vers les coupables.

Bien que l'aléa moral soit utilisé aujourd'hui pour désigner des comportements frauduleux des institutions financières, cette notion prend son origine dans le monde de l'assurance. Elle décrit la tentation, voire l'inclinaison des assurés à prendre des risques plus élevés que les non-assurés. Il est important de distinguer clairement entre la "tentation de prise de risques" et la tentation de "simuler" afin de frauder ainsi l'assurance. A partir de cette distinction, nous pouvons analyser les aspects éthiques de l'aléa moral.

and is it really immoral? This essay will attempt to answer these questions.

Who are the moral gamblers?

The concept of moral hazard originates in the insurance sector, even if more recently the term is usually employed to refer to fraudulent practices in financial institutions. It describes the tendency of an insured party to assume greater risks than a non-insured party owing to the apparent security that possessing insurance carries with it. Along with the exponential growth of insurance companies in the late 19th and the early 20th century, the use of the term became increasingly widespread and its underlying problem more and more important (Dembe & Boden, 2000). Behavioural change resulting from the insured being protected by an insurance policy was frequently an issue in relation to automotive, property and social insurance and highlighted a significant increase in the carelessness with which people entered into insurance agreements. As early as in 1913, Isaac Max Rubinow (1913), known as the father of the American social insurance system, drew a distinction between "the temptation of risk" and "the temptation of simulation". "In the opinion of many," wrote Rubinow, "the most destructive is a conviction that social security not only increases risk, but significantly encourages the simulation of accidents, illness or lack of employment, lets alone professional

begging, and corrupts the entire working class by offering an easy reward for cheating." It seems that moral hazard is of a dual nature: the first associated with excessive risk and the second manifested in embezzlement and fraud. The latter is unquestionably unethical; the former will be evaluated below.

However, moral gamblers are not only the parties to insurance agreements. In the United States the 1920s saw a discussion about the introduction of deposit insurance, thereby moving the debate about moral hazard into the banking sector. In such a case, the temptation of abuse surfaces with reference both to the government support for banks, taking the form of deposit insurance, and to the institution of the central bank as the lender of last resort. A moral gambler can thus be a bank pursuing an excessively risky activity which is secured by guarantees from its parent organisation and possible public aid. However, it also seems necessary to distinguish between negligence or carelessness concerning certain security standards, and advocating intentional fraudulent practices intended to mislead market participants in general or, more specifically, the other party involved in the agreement. Given that the second scenario (intentional fraud) is clearly unethical, let us concentrate on evaluating the first (negligence or carelessness).

To start with, it is worth considering the very purpose of having an insurance system. Is it not designed precisely so that the insured party

Le système d'assurance est nécessaire au développement des activités impliquant la prise de risque. Sans assurances, les possibilités de crédit offertes par les institutions financières seraient bien moins étendues qu'aujourd'hui. Certains philosophes vont même jusqu'à dire que ni Christophe Colomb ni Neil Armstrong ne seraient partis dans l'inconnu à la découverte si leurs familles n'avaient pas été assurées au cas où leurs missions tourneraient mal.

Les récents sauvetages des banques ne découlent pas de leur droit illusoire à être préservées de la faillite, mais de droits fondamentaux des citoyens au bien-être et à la prospérité. Le soutien à la liquidité des banques est donc justifié du point de vue éthique seulement si cette obligation est dérivée du droit des citoyens à une vie décente. En conséquence, la

takes greater risks? If we imagine, for example, that motor insurance were no longer compulsory, we would expect a massive increase in the cost of vehicle use and a reduction in vehicle owners' peace of mind.

Were Columbus and Armstrong the moral gamblers?

Repair and maintenance expenditure, difficulties in enforcing claims and, finally, the likelihood of very conservative driving generating extra congestion would lead to a visible decline in the number of vehicles on the road. Insurance solves such problems, at least in part, and insurance companies assume that drivers are careless and calculate their premiums accordingly. The same applies to other types of insurance, for example, travel or holiday insurance. Perhaps some people would give up hiking, scuba diving or skiing without if they did not have the psychological buffer of accident insurance in place. Some philosophers even surmise that Columbus would not have discovered America and Armstrong would not have set foot on the Moon if their families had not been granted financial support, thus taking their share of the risk had the mission failed (Hale, 2009).

However, while the relationship between moral hazard and great discoveries is questionable, it seems more than likely that the lack of security and insurance in financial institutions would considerably restrict the availability of credit, thus arresting

economic growth. After all, banking operations are invariably risky. The asymmetry of information along the bank-customer line and a number of external factors make uncertainty an inherent attribute of financial markets. Furthermore, securing even part of the potential losses catalyses further operations in these markets and expedites their growth and development.

But again, we need to make a distinction between risky activities and fraud or embezzlement. Some people do not consider breaking a traffic rule immoral; the same with skiing headlong down a very steep slope or purchasing shares in a joint venture project. By contrast, begging for compensation after a fake accident, or pursuing creative accounting practices to lower risk indicators would no doubt be seen as immoral. It goes without saying that the former set of actions is somehow embedded in insurance market scenarios, while the latter flouts any generally accepted moral principles.

One hazard two faces

Bearing that in mind, can overexposure to risk without the intent of cheating or concealment of information be justified, and can we consider this kind of moral hazard ethical? To answer this question, some differences must be taken into account between a standard insurance agreement and agreements concluded in the banking sector, which, comprising of institutions representative of social trust, is governed by certain specific rules.

justification de la recapitalisation du secteur bancaire ne signifie en rien que les individus qui sont à l'origine de cet état de fait ne devraient pas être mis à contribution. En dernière analyse, il s'agit de protéger les citoyens, non pas les banques ou leur dirigeants.

Il semble impossible de trancher de façon ultime si certaines actions sont bonnes ou justes et droites. D'autant plus que dans certaines circonstances, elles pourraient apparaître comme absolument justes, alors que dans d'autres elles seraient inappropriées. Il est difficile de traiter les questions de moralité de manière non équivoque pour une simple et bonne raison : il n'y a pas de définition générale et universellement admise de la moralité. La question de savoir ce qu'est la morale est susceptible de nombreuses réponses

First, an “ordinary” agreement with the insurer is a voluntary business contract; on the other hand, the relationship between banks and their public “administrator” is in a sense a social agreement that meets all the requirements arising from the assumptions made by Hobbes and the canonical theory. If, therefore, we agree that this agreement protects the wider community interests, any violation of the contract must necessarily be considered immoral. But here again, the question is raised: Do we know what the deal is ?

Despite appearances, this question is far from simple to answer. Let us focus first on the commitments which the government makes in this agreement, and on any moral obligation it might have to save the banking sector from collapse. The answer can be found in Article 25 of the Universal Declaration of Human Rights: “Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family.” Based on this fundamental right, the government should be assuming a moral obligation to protect its citizens from crisis that might significantly decrease their standard of living. Consequently, rescue packages or programmes are not implemented as part of the banks’ fundamental right to be protected against failure, but as part of the citizens’ fundamental right to well-being and prosperity. Several important conclusions can be drawn at this point: supporting the liquidity of banks is ethically justifiable, yet the obligation to provide such support

only stems from the citizens’ right to an acceptable standard of living. It follows, therefore, that if in any given circumstances there exists a method of asserting this right which is more morally acceptable, this method should be adhered to .

However, if saving people rather than banks is a moral duty, there is certainly no moral duty to save bankers who have acted in a way which threatens social prosperity. Any justification of recapitalisation of the banking sector does not mean that the individuals who are to blame for the existing state of affairs should not take responsibility. Mind you, we protect citizens not banks, let alone bank executives.

A more complicated dilemma presents itself concerning the moral obligation of banks to operate in a manner that rules out the need to apply for government aid. The content of the social agreement in this case is imprecise . The boundary level of risk preventing liquidity issues cannot be established. It could also be possible to gain a public consensus of opinion over what is an acceptable level of risk for banks to take. Any organisations which have crossed this boundary would be labelled immoral. However, obtaining a general social consensus on this issue is not possible. In addition, information asymmetry and the number of variables which have an impact on a banks operational risk is so vast that it is not possible to accurately assess an operation’s level of uncertainty. More than that, the low level of risk translates into high

basées tantôt sur la religion, tantôt sur le droit, ou encore sur les émotions ou sur les normes sociales. Ces réponses sont abordées dans le texte et elles serviront de base pour traiter la question de la (im)moralité de l'aléa moral.

Serait moral ce qui est acceptable pour la majorité ? Pour paraphraser G. Frege "être moral est différent d'être considéré comme moral par une autre personne, par beaucoup d'autres voire même par tous. En aucun cas, la question de moralité ne devrait être réduite à cet aspect". Il n'en demeure pas moins que nous ne savons toujours pas ce qui est considéré comme moral par la majorité. Être moral, c'est suivre des principes comme le rappelle I. Kant avec son impératif catégorique. Être moral, c'est être inspiré par de bonnes intentions. Fondamentalement, l'aléa moral se réfère uniquement aux comportements

interest loans, while, evidently, the public expects the supply of capital at the lowest price. A high volume of loans, especially which stimulate capital expenditure, is highly desirable in the economy. How, in this case, is the social agreement formulated and should excessive risk coupled with almost free mortgage loans be considered a violation of this agreement? Answering this question would be to state the obvious...

What is "moral"?

Questions of morality are usually difficult to address in an unequivocal manner. The reason for that is fairly simple: there is no single and generally applicable definition of morality. "What is 'moral'?" Numerous answers can be given to this question, based on religion, law, emotions, or social rules. Below I will share the answers that I hear most frequently and will attempt to refer them to our exploration of the (im)morality of moral hazard.

"Moral is that which is good." Nevertheless, we must ask, good for whom? And what if today's good proves a disaster tomorrow? Looking back to 2006, we could ask millions of Americans whether buying a property at a 100% mortgage and a very low interest rate is acceptable. We could ask bank executives whether paying themselves high bonuses for profit while being reluctant to take any consequences for possible losses is acceptable. We could ask US congressmen whether it is acceptable to earn the support of poorer voters

thanks to such government institutions as Freddie Mac and Fannie Mae assuming almost the entire risk of repayment of the most vulnerable loans in bank portfolios. Let us ask the same Americans whether it is acceptable to be one of the 7 million people evicted from their homes. Is it good to be ostracised and have pockets lined with junk shares of your own bank? And finally, it is acceptable to initiate rescue programmes paid by newly printed or taxpayers' money? Therefore, should we conclude that this hazard is good or bad?

"Moral is that which is righteous." Here again we approach the same dilemma: who should determine what is righteous? In the long dispute about moral relativism, the Cartesian understanding of certainty as an attribute of knowledge is often disparaged. If, like the absolutists, we refer to ethics as a science of morality which provides justifications based on a critical scientific methodology, we are forced to reject the standards of those cultures which lack any considerable scientific legacy or which treat science differently. Consequently, the problem arises of whether we are able to propose such a set of rules or methods of their determination that will hold true universally and will protect the legitimate interest and welfare of everyone. If we answer in the affirmative, further problems ensue. How can we objectively lay down such rules? Who is qualified to verify that impartiality? And, finally, once verified, how can we make sure that the assessment is correct? After all, there

intentionnels. Dans cette acception de moralité, les banques qui n'ont pas manipulé leurs états financiers et n'ont pas délibérément diminué les indicateurs de risques devraient être considérées comme ayant agi moralement.

Est moral ce qui vaut la peine d'être répété. Or, si l'on pouvait savoir de manière ultime si ce qui vaut d'être répété est juste, il serait plus facile de discuter de moralité. Sans cela, tout dépend de l'interprétation.

Est moral ce qui est conforme à la justice ... L'exigence de base ici est de savoir quelle est le principe de justice : le traitement égal, ou le "à chacun selon ses besoins". Dans le secteur bancaire, quel sens faut-il donner à la justice face au refus du gouvernement d'aider Lehman Brothers alors qu'il recapitalisait d'autres banques à court de liquidité ?

are people for whom the development of financial markets, even at the cost of issuing high risk derivatives, constitutes the only correct view of the evolution of the financial system. Still, there are those who continue to regard government assistance to financial institutions as a legal reward for thoughtlessness or an anti-market support for losers. I have already outlined some well-grounded arguments that contradict both of these theses. Yet, the supporters of either of them should not be denied accurate judgement. Considering the above, we should see eye to eye with Jesse Prinz who rejects reasoning as a method of seeking moral values (Prinz, 2011). Of course, he does not challenge the significance of reasoning in developing moral principles, yet he claims that it ultimately and always refers to emotions.

Some other definitions of morality

"Moral is that which is accepted by the majority." To paraphrase Gottlob Frege, "being moral is something other than being considered moral either by one person or by many, or even by all, and in no case should it be reduced to this alone" (quoted after: Niebrój, 2012). However, even if we reject this argument, at this point we should return to our discussion of the content of the social agreement concluded between the public and the banking sector and consider whether the level of risk taken by banks was actually rejected by citizens. Perhaps the blame should not lie with banks if they reasona-

bly interpreted public expectations as permitting or even encouraging high risks. The information about this public acceptance may have been obtained from political and social institutions, in a sense legitimizing the desired level of risk as socially permissible. Therefore, banks can be said to have acted within the framework of existing standards and their activity did not violate the social agreement (Claassen, 2015).

"Moral is following principles." At this point, it is impossible to ignore Immanuel Kant and his duty imperative. He says that a moral act is committed out of duty while anything which is done out of desire is either neutral or reprehensible. Let us ponder in what way a bank's obligation can be considered superior. Besides meeting legal requirements, the most important obligation is to act diligently, which stems from the standards of corporate governance. It is commonly defined as being vigilant to detect any potentially important issues. Although it is impossible to objectively verify how vigilant someone is, an intuitive assessment leads to the conclusion that this obligation was not duly satisfied by banks.

"Moral means guided by good intentions." Surprising as it may seem, people often judge intentions and not consequences. Imagine a situation in which the government provides monetary aid to banks suffering from an environmental disaster. Would any opposition be voiced? Basically, moral hazard covers only intentio-

Il est facile de juger ex post. L'aléa moral ne doit pas toujours être considéré comme immoral. Laissant de côté le cas de l'abus, qui relève, à l'évidence, de la fraude, les autres situations sont difficiles à juger. En conséquence, ni les banques agissant dans le respect de la loi et avec le soutien euphorique des débiteurs, ni les gouvernements cherchant à éviter un effet de domino, ne méritent d'être unanimement ostracisés.

L'aléa moral est-il toujours immoral ? Non, pas toujours ; même bien moins fréquemment que nous ne le pensons. Pour justifier cette thèse potentiellement controversée, je me réfère à la langue polonaise qui parle littéralement de la "tentation d'abus". Or, la tentation est-elle immorale, ou bien seulement le fait de lui succomber ? De plus, dans notre cas, nous devrions savoir exactement de quel abus on parle. De la

nal behaviour; again, a distinction should be made between the behaviours focused on the promotion of welfare and those chasing fraud and embezzlement. With such an understanding of morality, banks which did not cheat in their financial statements and did not deliberately lower risk indicators should be regarded as acting morally.

Are moral acts always worth repeating and fair?

"Moral is that which is worth repeating" I will eat my hat if anybody can tell me which elements of bank or government policies are worth repeating. Even today, a few years after the crisis, no clear position has been articulated on whether the governmental capital injections were right, and interest rates are again very low and encourage banks to oversupply credit. Eugene Dupreel in his *Traité de morale* says that acts that are desirable and worthy of praise tend to be repeated in one of two ways (Dupreel, 1969). Some of these acts, in addition to the value for which we praise them, are useful for the person carrying them out; some other acts, by contrast, are harmful or unpleasant. Dupreel notes that the acts of the former kind do not need praise because the doer does not deserve any special merit. Only the acts of the other kind, as the author underlines, garner praise and recognition to the doer. "Morally good acts are those which go beyond remaining in line with specific rules or laws, and

require the perpetrator to be ready to sacrifice." Indeed, governments demonstrated their willingness to help and even made real sacrifices, whereas banks behaved in quite the opposite fashion. Major scandals involving the return of monetary aid only to be given the green light to pay staggering bonuses to managers testify to the deficiency of banks' willingness to contribute their part.

"Moral is that which is just." If this is so, it will prove beneficial to briefly explore the principle of justice: "Nobody deserves things merely because it is him or her and not somebody else," reads one of the definitions (Ajdukiewicz, 1960). "Do the same in identical circumstances," reads another one (Chwistek, 1936). However, even this apparently simple rule raises serious doubts. The basic requirement is to make it clear whether "just" means (to do) "equally to everyone" or "everyone according to their needs." If we go for the needs, which seems more compelling anyway, then someone else should be able to measure such needs. Accepting or distributing? Looking again at the banking sector, how does this principle refer to the fact of refusal of governmental aid to Lehman Brothers, while recapitalizing others running the risk of illiquidity? The only explanation is that Lehman Brothers was assigned to another fundamental category, which would justify the government's attitude to other salvaged institutions. Or maybe, in this case, justice does not come into play?

manipulation d'états financiers – certainement. Mais qu'en est-il de l'"exposition excessive aux risques" si décriée aujourd'hui ? Qu'en est-il de ces swaps en milliards indispensables à la stratégie bancaire ?

Selon F. Nietzsche, il n'y a pas de phénomènes moraux, mais seulement des interprétations morales des phénomènes. Ces paroles captent l'essentiel de la discussion sur la tentation de l'abus. De même, la moralité de l'aléa moral est une question d'interprétation. Il n'y a pas une seule opinion juste, pas même l'opinion publique. Il est facile de préférer des jugements post factum, en oubliant l'enthousiasme général aux temps de la prospérité. Et, peut-être, après tout, lorsque nous attendons tous avec impatience la prochaine reprise économique, sommes-nous un peu immoraux ?

It is easy to judge post factum

"I know one thing: that I know nothing", you would like to say with Socrates. An attempt to put together the pieces of reflection on moral hazard reveals how complex the problem is. The only thing that is clear is the origin of the term, the rest meanders between dilemmas and subjective judgements. Still, some conclusive remarks are needed to add some value to all these deliberations.

Is moral hazard always immoral? No, not always; even less frequently than we tend to suspect. To justify this, perhaps controversial, thesis, it would be advisable to refer to the Polish synonym of the term. A temptation of abuse: can this be immoral in itself? What about saints? Weren't they tempted? Succumbing to temptation would certainly be considered immoral, but in our case, it is necessary to clearly define what an "abuse" is. No doubt, it is the manipulation of financial data in order to obtain the best possible rating. It is also the obscured level of risk associated with sold derivatives. It is also disinformation and non-transparency of operations. These are some obvious cases of abuse regarded as economic offences – their morality, or rather the lack of it, needs no further exploration. But what about that rather stale slogan from today's perspective, of "excessive exposure to risk"? What about those millions of mortgages that should never have been sold? What about those derivative

instruments that were so complex that no one knew what they relied on and how much they were worth? What about those billion-dollar swap transactions and forward and futures contracts that should be considered more of a guessing game than the implementation of a bank's strategy? And if all that occurred in accordance with the law and with the unanimous approval and euphoria of borrowers and investors, should it be considered immoral? Perhaps, in one case only: if the bank authorities had known or had been able to predict how this madness would end. Given the sheer panic, bafflement and giant stocks of own shares that the bank executives ended up with in 2008, it is no surprise that it did not dawn on them earlier.

And what about state authorities? This question is simpler to answer. They should by all means fight to prevent the devastating domino effect and stop the crisis phenomena looming over the economy. As long as no one proposes a better method than liquidity packages, they have no other choice. Indeed, this is not true that banks were transferred extra capital: government aid mostly involved the redemption of less liquid assets or granting long-term loans to those institutions that pledged the tightening of their financial security policies. Again, supporting banks is not tantamount to supporting their directors or managers. Indeed, they should bear the consequences of their incompetence. For each of the salvaged institutions such incompe-

tence can be proven, since their decision-makers were not able to predict the disastrous effects of the property bubble.

Conclusion

“There are no moral phenomena at all, only moral interpretations of phenomena” – Friedrich Nietzsche’s words best fit the discussion of the temptation to abuse. Also the morali-

ty of moral hazard is a matter of interpretation, emotions and outlook of the evaluator. There is no single and the only right opinion, let alone the public opinion. Passing judgements *post factum does not prove in the least demanding*, if one conveniently fogets the overwhelming enthusiasm in the time of prosperity. After all, perhaps all of us who are forever awaiting the economic boom are a little immoral?

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