

# Moral Hazard Vs. Systemic Risk

The 2008 U.S. financial crisis, the 2010 sovereign debt crisis in Europe and the current Greek financial crisis all presented policy makers with the dilemma of having to choose between creating a moral hazard and saving a system from systemic risk. Moral hazard means that people with insurance may take greater risks than they otherwise would because they know they are protected. A moral hazard is created when banks lend more recklessly because they know they will be bailed out if things go wrong. Bailing out the banks reinforces the belief they will be protected from reckless lending, which could result in more irresponsible lending in the future.

In similar fashion, irresponsible borrowing by governments in Europe (Portugal, Italy and Greece) is reinforced because they know they will be bailed out by the IMF, World Bank and the European Central Bank if things go wrong.

Systemic risk is the likelihood of damage being done to the health of the system as a whole. It is the risk of collapse of an entire system or entire market, as opposed to risk associated with any one individual entity, group or component of a system. It refers to the risks imposed by inter-linkages and interdependencies in a system or market, where the failure of a single entity or cluster of entities can cause a cascading failure, which could bankrupt or bring down the entire system or market.

A constant concern of bank regulators is that the collapse of a single large systemically important bank could bring down the entire financial system. A constant concern of the Western European nations is that a Greece debt default will have a contagion effect on other countries with high debt levels that could bring down the entire Euro project. The concern goes beyond financial impacts to include political anxieties about leaving the Euro currency and the integration of Western Europe.

Faced with a choice between creating a moral hazard and avoiding systemic risk, policy makers will almost always choose the latter. No politician or policy maker wants to risk the collapse of the financial system or Euro project while they are in power. Politicians also have a short-sightedness bias. This is because the consequences of systemic failure are immediate and highly noticeable. The problem of moral hazard isn't as noticeable and typically occurs sometime in the distant future when the policy maker may no longer be in office.

The overwhelming predisposition in favor of preventing systemic risk is so strong that it will trump long-standing rules and economic values.

Hank Paulson, the treasury secretary in 2008, is a strong believer that free markets should determine which institutions fail and which do not. However, as the financial crisis loomed, Paulson and President George W. Bush took action contrary to their long-held beliefs about the economy to avoid risking the collapse of the financial system and took action that created a moral hazard.

With Greece, the IMF violated its longstanding rule under which it would not lend to a country unless a rigorous analysis showed that there was a "high probability that debt will remain sustainable."

In 2010 the IMF wrote an opened exemption. New loans can be made in unsustainable situations so long as there was a "high risk of international systemic spillover." The IMF claimed this was the case with Greece, and Greece got their loans in 2010. More recently, Greece was bailed out again to avoid systemic risk.

After the financial crisis, the proposed solution to avoiding the moral hazard vs. systemic risk dilemma is to enhance government regulation. Proponents of the 5-year-old Dodd-Frank financial reform legislation argue it will eliminate the problem of systemic risk and so-called "too-big-to-fail" financial institutions through capital controls, living wills and a commission tasked with identifying systemically important financial institutions.

This approach can be problematic for a number of reasons. Regulator memory of the crisis fades over time; regulations do not keep up with new technology; market conditions change; unintended consequences arise; and regulatory capture sets in. Regulatory capture is the process by which regulatory agencies eventually come to be dominated by the very industries they were charged with regulating. Escaping the moral hazard-systemic risk dilemma through Dodd-Frank is improbable. A superior approach is to find the balance between market discipline and government regulation.



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