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The triumph of moral hazard

By Karl-Heinz Thielmann

I have to admit that I have been wrong. Until recently, I was one of those persons who spent their time complaining that many people in the financial industry had not learnt anything from the crisis. But, in the meantime, I have changed my mind. These people have learnt something - and that is that misconduct pays off. Moral hazard, or inconsiderate behaviour at the expense of others, is worthwhile. It therefore makes sense to carry on as before.

Moral hazard was identified as one of the main causes of the financial crisis very early on. Mainly investment bankers had created and marketed products that involved high levels of risk for the general public, yet yielded considerable premiums for themselves. When the bubble burst, clients, tax payers and shareholders picked up the tab. The perpetrators, on the other hand, rarely lost a cent.

A key reason for the success of inconsiderate behaviour is that the economic system has changed over the last decades. The link between the cause and the reward (or penalty) has been broken.

Broadly speaking, capitalism functioned as follows in the past. An entrepreneur had a great idea for a new product. He organised its production and transport, added a margin to his costs, enabling him to make money. If the customers liked the product, the entrepreneur would become wealthy. If, however, the customers did not like the product or did not trust the producer, they would stay away and the entrepreneur would be punished with financial losses.

Speed Read:

- Despite moral hazard being identified as one of the main reasons for the financial crisis, no serious efforts have been made to tackle it on financial markets.
- The link between risk-taking and the penalty for failing remains broken. Bankers still have an economic incentive to cause harm to their customers with intransparent products.
- Financial regulation has focused on reducing the potential impact of the next crisis on the overall economy and the taxpayer. However, it has done nothing to prevent acts of moral hazard.
- Actions by legal and political bodies have mainly punished shareholders, while responsible managers have remained untouched or even come off better after their failure. Risk management in financial institutions is as ineffective as it was before the crisis.
- Measures to reduce irresponsible behaviour must re-establish a link between the origin of the risks and the punishment for failing. Because no serious efforts have been made to do so, it is justified to speak of a “triumph of moral hazard” as result of the financial crisis.

This is how capitalism works today. There are only very few entrepreneurs in the classical sense (people like Steve Jobs or Richard Branson can be considered an exception to this rule); instead, the market consists of large corporate groups. As a rule, they no longer have ideas for great new products. So they take a look at the existing products and "re-pack" them, making them look newer and better than the old ones. This is only possible if they either 1) invent additional new product features or 2) conceal the weaknesses or risks associated with them. If the customers buy into this game, the group makes high margins and the managers and shareholders grow rich. If this does not work, the managers still become rich but the shareholders, on the other hand, become poor.

The consumer goods industry has largely taken the first route. Advertising and different product features give the product an "added value", albeit often merely psychological. The objective is to "trigger desires", to quote a BMW board member, which are fulfilled if an appropriate price is paid. There are mixed opinions as to whether this is exploiting small human weaknesses or genuinely doing something better. The fairest approach would probably be to examine each case individually and avoid sweeping statements.

The financial industry has mainly picked the second route. This is reflected by the boom in so-called financial innovations since the mid 1980s. In actual fact, these financial innovations are not particularly innovative but are merely re-packed versions of basic products that already existed. This is because, essentially, the bank industry's products have been the same for centuries: loans to finance trade, investments and real estate; deposit taking; provision of equity capital; investment consultancy and asset management; trading in stocks, bonds and financial futures on the stock exchange.

Nevertheless, these standard products have been adapted to changing technologies and legal conditions on an ongoing basis. In the last decades, in particular, this has resulted in many positive new developments, e.g., index funds that save costs for bank customers and greatly simplify business.

However the word "financial innovation" is also associated with a negative development. Indeed, it is the marketing label given to financial products that are not a logical adaptation to the new market requirements and opportunities, but are products that **conceal costs and risks**. Very significantly, this word is rarely used in connection with index funds, which are a genuinely useful invention (introduced by a "classical entrepreneur", Jack Bogle). Instead, this term generally refers to so-called "structured products". These are financial instruments whose value development is linked to that of other securities, sometimes in an extremely complex manner. They often also have a derivative component. Structured products have been highly popular among providers of financial products for years. This can be put down to their lack of transparency, which enables providers to factor in hidden costs. And, unfortunately, it enables them to conceal the risks.

Ten years ago, the most appealing structured products in the USA were so-called CDOs (collateralized debt obligations), in particular for security-oriented investors. They were made up of portfolios of fixed-income securities that were generally not easily tradable. For this reason, they were grouped together in a special purpose entity, which issued bonds with varying degrees of risk. The benefits were obvious. Illiquid investments could be traded and, depending on their risk appetite, investors could access investments with a significant mark-up on government bonds. The drawback was that in reality the risk situation was far from transparent. At the end of the US real estate boom after 2006, a growing number of dubious securities ended up in CDO special purpose vehicles, a development that was not visible to buyers. We all know what happened next. In 2007 the bubble burst, the CDOs turned bad and a growing number of banks found themselves in precarious situations and had to be rescued. When the US Government did not come to the aid of Lehman Brothers in 2008, the ensuing shock waves almost destroyed the entire global financial system.

Hank Paulson, US Secretary of the Treasury and previously "old-school" investment banker, wanted to take a stand against moral hazard by refusing to support Lehman Brothers. He failed miserably. Because his decision revealed one thing only - that the havoc wreaked by punishing misconduct in the financial industry is a much greater evil than using tax payers' money to compensate the losses made by gamblers. In fact it was a clear demonstration of just how easily the world can be blackmailed by unscrupulous bankers.

You may argue that a multitude of initiatives and new regulations have been introduced over the last five years to tackle the causes of the financial crisis. Upon closer inspection, however, these measures are largely attempts to limit future damages. The core problem - the fact that bankers have an economic incentive to cause harm to their customers with intransparent products - has not been solved.

If we look at the specific changes in detail, it becomes clear how superficial they are:

1) Regulation

Many people consider the excessive deregulation of the financial sector to be one of the causes of the financial crisis. Therefore one consequence was obvious - more regulation. Since 2008, there has been a growing flood of regulations, directives, liability clauses, eligibility criteria, information sheets, minimum requirements, etc. across the globe. However, this has merely resulted in an extreme bureaucratisation of all processes and the inflation of costs for banks. Respectable financial institutions are increasingly withdrawing from some segments, for example, from investment consultancy in Germany. It is simply not reasonable to expect consultants to plough through a seven-page form per customer in order to keep consultation records. As a result, banks either break the law by failing to keep records or by imposing records on customers that they do not understand. Alternatively, the banks abide by the law and frustrate customers with the red tape before proceeding to consultancy and sales. Because customers generally opt for the easiest route, many often end up consulting financial rogues who do not waste time filling in tedious forms or informing customers on risks.

The equity capital requirements for banks have been tightened to avoid using tax payers' money if problems arise again. However, as business practices have basically remained the same, the threat of another catastrophe has not been contained, only the damages for the tax payer have been mitigated. Furthermore, the equity capital regulations and the calculation of requirements are still based on the approach of "risk-weighted assets". This gives preference to government bonds rather than corporate loans. The Euro crisis has shown how questionable this approach is: on the one hand, because government securities can also involve substantial risks and, on the other hand, because it redirects investors' money into the state treasuries, thus failing to provide investment loans for business.

If life is made so hard for respectable providers of financial services, one can only assume that the supervisory authorities believe that the entire financial industry is not trustworthy. Because then it makes complete sense to supervise them as closely as possible. The underlying rationale of the equity capital requirements is an attempt to ensure that the system is capable of absorbing the consequences if a speculation bubble should burst again. This means shifting the liability risk from the state to the shareholders. Although there is nothing wrong with this approach in principal, the potential perpetrators - the ruthless managers - remain untouched.

2) Justice

There have been a series of criminal proceedings against hedge fund managers and investment bankers for manipulative and fraudulent business practices. These have almost always only resulted in fines, which have mainly been paid by their institutions (and ultimately the shareholders) or, in some cases, also by their management liability insurance. The perpetrators have rarely been sentenced to prison, as was the case for Bernhard Madoff, who committed a fraud based on a Ponzi scheme. Many managers have been forced to resign; the majority of them, however, pocketed fat severance payments when they left. The practice of handing out "golden parachutes" has resulted in risk-taking at the expense of customers and shareholders, with absolutely no risks for the actual perpetrators, who even have a financial incentive to do so.

Nassim N. Taleb challenges financial managers to "skin in the game" - or risk their own skins - when taking risks. Investment banking was originally organised in the form of partnerships. If managers took high risks, they put both their own assets and those of their partners on the line. They were responsible for their partners' capital and acted accordingly. At that time, there were no systemic risks. These days, however, anonymous shareholders and tax payers bear the brunt of the mistakes made by managers - an invitation for managers to help themselves.

It has become popular to express outrage about excessive management remuneration packages. However, the commotion entirely misses the crux of the issue. Why should a manager who performs well and makes sound business decisions not earn a good salary? To be honest, I do not see why not. However, it can become a problem if there is no link between the remuneration of a manager and his performance. But with a severance package he can end up with more money if he fails than if he succeeds. This cannot make sense.

3) Politics

One of the paradoxes of history is that politicians pushed for the introduction of a tax on financial transactions in some countries to "make the perpetrators of the financial crisis contribute towards the costs." However, this tax is not particularly high. In addition, it mainly hits the bank customers - in other words, the victims of the financial crisis. The same people are the losers again.

Legal provisions that regulate the personal liability of bank managers would really help. Following the bursting of the Internet bubble in 2000, several cases of fraud were brought to light, resulting in long prison terms for high-profile managers in the USA who had committed accounting fraud. This has acted as a deterrent to others. However, the top managers responsible for the financial crisis have not been charged, and almost all of them live very nicely from their capital.

4) Risk management

In its edition of 7 September 2013, the Economist stated that the obvious cause of the financial crisis was, "the financers themselves...who claimed to have found a way to banish risk when in fact they had simply lost track of it." So bankers have not only lied to their clients, but also and above all have lied to themselves, because they have been drawing up risk assessments with almost mathematical precision that are complete nonsense.

The way the financial markets deal with risk has hardly changed for years. This is particularly surprising as Nassim N. Taleb's bestseller "The black swan", published in 2008, clearly set out the fundamental problems to a wider public. In particular, the continuing popularity of the "Value at Risk" performance indicator speaks volumes. It massively underestimates the effects of rare extreme events. This has been known for some time and, indeed, it has been discredited since 1998, when turbulences regarding the debts of emerging economies and the ensuing bankruptcy of the LTCM hedge fund revealed the weaknesses of the concept. Two consequences should have been drawn from this: a) to renounce using it entirely because uncertainty cannot be quantified or b) to apply modified concepts such as Modified Value at Risk (MVaR) or Conditional Value at Risk (CVaR), in which some of the flaws have been ironed out. I prefer the first approach; many risk mathematicians prefer the second. Time will tell which of us is right.

However, using Value at Risk in its original form should not be permitted. Nevertheless it is still the normal and most common procedure implemented in day-to-day risk management and is, indeed, encouraged and supported by regulating bodies.

The fact that this approach remains unchanged may be due to stupidity, ignorance, inability to learn from mistakes or, indeed, wilful deceit. It is not for me to comment. However, the fact remains that the financial industry is dealing with risk as naively as five or fifteen years ago. If an asset manager claims to provide "professional risk management", customers should see it as a warning sign.

The business model of most banks is still driven by transactions. They can only benefit from customers if they make as much turnover with them as possible, which automatically motivates them to either risk or reduce their customers' capital. This deeply rooted conflict of interests is the basic evil of the industry. Although it is widely known, it is rarely questioned.

There are conflicts of interest in other industries. However, they are dangerous in the financial sector because of the lack of transparency of products and the irresponsible behaviour of managers. Can you imagine a car manufacturer installing low-quality brakes in a new vehicle intentionally or by gross negligence? And can you imagine car purchasers having to sign a multi-page record stating that they are aware of the risks of the possibly low-quality brakes and are prepared to bear the consequences? Of course not. This is why we all drive around in cars that are relatively safe. And when accidents happen, it rapidly becomes clear that the mistakes are predominantly made by the car drivers. Customers suffering from damages therefore very rarely try to blame their own stupidity on the poor quality of products.

Almost anybody working in the financial sector - from bank counter staff, investment consultants, and board directors through to inspectors - admits that there is something fundamentally wrong with the industry. Each of them can tell countless tales that demonstrate the absurdity of their day-to-day working lives. But only very few of them have actually drawn the necessary consequences. They know that they are doing the wrong thing, but continue along the path because they have a strong economic incentive to do so. They simply do not know how to finance their standards of life in any other way.

If people are not prepared to question fundamental issues, nothing will change. And this is what they should be doing:

- Both private and institutional **clients** like to dismiss the risks and prefer to hear unrealistic promises of returns. As long as they prefer investment advisers who tell them what they want to hear and promise safe, easy, high-yield investments, they will automatically end up in the hands of con artists.
- **Banks** should no longer measure their success on the basis of the short-term turnover they generate from their customers, but rather in terms of their ability to sustain long-term customer relationships. In particular, bonuses should no longer be paid to employees who sell products with hidden risks to customers. This is not a pipe dream, not even for large banks. The Swedish financial group Handelsbanken already changed

its business model 40 years ago, mainly restructuring its incentive system. Since then the loan defaults have been below the industry average in times of crisis. Long-term incentive plans ensure the loyalty of management, and there are no bonus payments. This benefits both customers (the bank regularly wins customer satisfaction surveys) and the shareholders (the share price has more than doubled over the last ten years in spite of the financial crisis). But the bank has not emerged as a model for other financial institutions outside of Scandinavia. This must be because leading bankers still hope to reap greater personal benefits from short-term rip-off deals, and the shareholders do not seem to mind.

- **Investment banking** is deal driven; cashing in on long-term relationships goes against the nature of the business. Investment banks should therefore re-establish partnerships and introduce loss participation. Alternatively, financial penalties could be implemented when deals fail.
- **Financial supervisors** need to shift their focus. Their primary objective should be to prevent another financial crisis from happening rather than mitigating the consequences of a financial crisis. Regulation should move away from codes of behaviour and formal requirements. Instead, it should turn its attention to: a) boosting the transparency of financial products; b) abolishing financial incentives for misconduct; c) ensuring that the perpetrators no longer pass on the damages to others - i.e. to shareholders, customers or tax payers - but that they take responsibility for their own actions by also risking their own money and, in extreme cases, being sentenced to prison.
- In the light of the rise in equity capital requirements, bank **shareholders** should be aware that they will be the ones that have to foot the bill if problems arise again. Surprisingly, however, they are not generally very critical of bank managements. Investors who base their decisions on expected profits for the next quarter implicitly tolerate rip-off practices and unnecessary risks. If the shareholders, as owners of the banks, do not call for banks to change their business models, they are not under any pressure to act.

As long as this remains unchanged, it will be worth hiding risks in the financial sector and offloading the consequences onto others. Therefore, moral hazard has established itself as business model because of the financial crisis - and not in spite of the financial crisis. There are far too few positive exceptions, such as Handelsbanken for example. This is a pity and does not only jeopardise the financial industry, but endangers the entire economy. In macro-economic terms, banks have an important function - that of bringing together capital providers and seekers. They currently accomplish this task for better or for worse, because they rip off the investors, on the one hand, and fail to differentiate between respectable borrowers and rogues, on the other hand. In countries with ageing populations, such as Germany, Japan or Italy, this factor could be critical for the economic future. Ageing societies cannot afford to waste investment capital. Successful private investors are needed to build assets, easing the burden on state pension systems, which are becoming increasingly difficult to finance.

Curriculum vitae of the author:

Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

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As an early reference to moral hazard as reason for the financial crisis, see for example: Michael J. Kosares: "Moral Hazard: The Real Culprit of the Financial Crisis" (http://seekingalpha.com/article/99963-moral-hazard-the-real-culprit-of-the-financial-crisis).

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The quote from the "Economist" is taken from the article "Crash course" in the issue of 7 September 2013 (http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article)

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