On Moral Hazard: The Moral Hazard of Limited Liability

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The Definition of Moral Hazard

Oxford Dictionary, ‘Lack of incentive to guard against risk where one is protected from its consequences, e.g. by insurance’.

Current concerns about moral hazard have been remarkably selective, mosly focusing on examples where the State has bailed out those who have suffered (foreseeable) loss from risk-taking, notably banks.

But limited liability for shareholders is probably the most important occurrence of this syndrome.

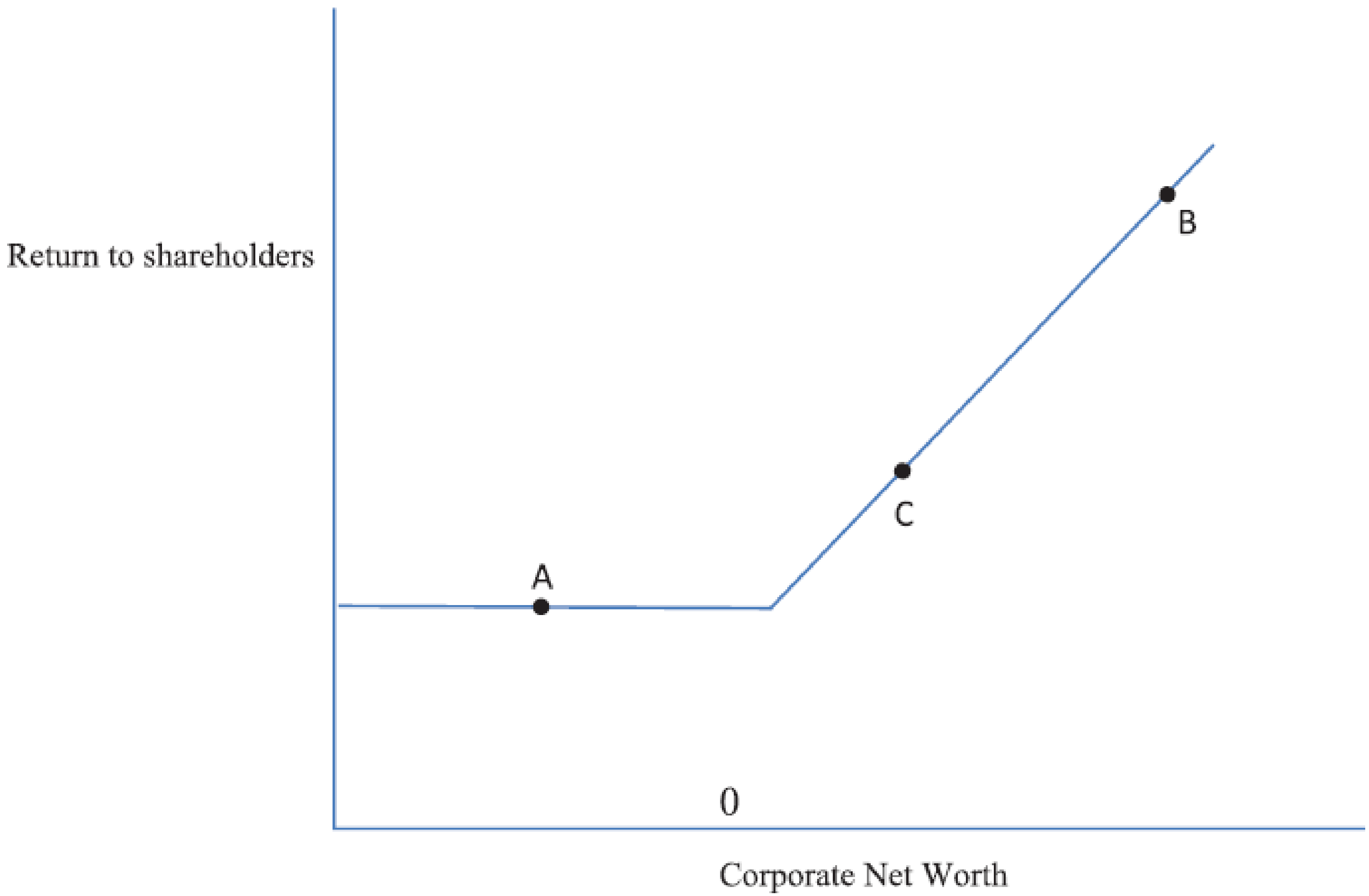

Figure 1. Shareholder preference for risk

How did we get to this stage?

Victorians were very aware and concerned about the moral hazard of limited liability, *especially* in the case of financial institutions, such as banks.

But need for scale requires equity participation beyond immediate family and friends, leading to sympathy for innocent outside shareholders in the event of failure. City of Glasgow bank failure, 1878, (Wikipedia).

Also, until recently, incentives of senior managers not so closely aligned with that of shareholders. This changes in the 1990s. Shift from straight pay to bonus system relating to (short-run) equity valuation. Easiest to achieve this latter via buy-backs and higher leverage, at expanse of R&D, longer-term investment.

Response has been Regulation

No doubt necessary, but it has inherent problems:-

1) Pro-cyclical; ‘That must never happen again’.
2) Leaves incentives unchanged, so regulation becomes a dynamic conflict, with regulators playing catch-up.
3) Regulation reduces profitability, hence induces shifts of business into unregulated channels.
4) Regulators have their own incentives, not always conducive to the public benefit.

Could one change Incentive Structure instead?

- Insiders vs Outsiders. Goodhart and Lastra, JFR (2020).
- Who is an insider?
- Various levels of power.
- What happens after leaving, or having concerns dismissed?
- What level of risk-taking do we want?
- Unforeseeable circumstances?

The Incentive Structures for Regulators

- Forbearance rather than closure.
- Regulators?
- Accountants?
- Credit Rating Agencies?

Conclusions

The most damaging aspect of moral hazard, i.e. limited liability, has not been seriously challenged.

Instead, the response has been to regulate activities. But this approach has inherent weaknesses.

Could/should we try an alternative, which is to alter incentive structures, to make those with power to influence decisions bear a significant part of the cost of failure?