

## A CREDIT MAN'S TAKE ON MORAL HAZARD

In the second blog of a periodic series, Ed O'Leary looks at the big-picture issue of "moral hazard" and how it relates to the individual lender.

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Second in a periodic series

Last week I shared my personal view that the way we have financed residential real estate since World War II substantially contributed to the real estate bubble. A 30-year amortization period and relatively low rates for much of the last 10 years or so contributed to unprecedented levels of real estate financing activity. Housing product was created at a pace that quickly outdistanced the ability of the market to absorb it, while at the same time credit was abundantly available and cheap. It's no wonder that we ended up with a bubble.

This abundance and availability of credit created another problem. And it ranks as the number two reason for our recent problems.

Too much of a good thing

Abundant credit led to a relaxation of credit standards. On top of that, too much competition among banks and non-bank credit providers led to a debasement of credit standards industrywide. Banks were scrambling to add earning assets to boost net interest income while the continued strong economy lulled most into a false sense of optimism on the outlook for continued strong loan demand.

It was probably inevitable with the inflation in housing prices that speculation became a component of the abusive practices in many markets. Taking advantage of both low rates and long amortization terms, people of ordinary means began to acquire real estate assets not for primary residences but for speculation. Significant fraud by unprincipled originators and borrowers alike resulted in additional elements of risk contributing to the excess and later collapse.

Speculation, greed, and opportunities for excess and fraud are facets of "moral hazard." This is a broad label. It consists of two different but related factors, which we'll now explore.

Making of moral hazard

Moral hazard can be understood to refer to a series of incentives, usually financial, that increase risk-taking activities and lead to higher levels of absolute risk. Many institutions have been accused of fostering imprudent activities fueled by incentives. These in turn produced what were subsequently discovered to be catastrophic levels of risk on their balance sheets. [Editor's Note: Banking regulators' attention to compensation practices, culminating in the June 21 issuance of final interagency guidance on the subject, is one of the regulatory results.]

Moral hazard, on the other hand, can also mean the absence of constraints on risk-taking activities. This can include internal cultures of growth and production that lack counterbalancing risk abatement processes.

Many observers also include the phenomenon of financial institutions that are considered "too big to fail" as a prime

component of moral hazard. If the institution will be saved or rescued by the government, there is a reduced incentive to behave prudently. The almost certain knowledge (and belief) that some financial institutions are too big to fail creates an environment for excessive risk-taking.

Under such circumstances, the marketplace tends to lack the usual sorts of constraints that inhibit risky behaviors.

It seems certain in retrospect that all of these types of moral hazard-excessive incentives to grow assets, lack of market constraints on risk, and "too big to fail"-were present in our financial system during this most recent business cycle.

What is not yet clear is whether the financial reform legislation working its way through the congressional legislative process will make any appreciable difference in limiting moral hazard.

Plenty of blame to go around

As I've noted before, the crisis had multiple causes. In fact, the list of causative factors of is long. Here are several others that belong on the list as well:

Excessive lending capacity among market participants and types of participants, that fueled imprudent risk-taking. The inevitable result? Depreciation of lending standards justified on the dual bases of competition and a lending environment perceived as less risky.

Excessive financial leverage made possible by flawed risk detection and measurement systems, as well as a dulled sensitivity to risk, owing to the abundance of and relatively low cost of credit.

Supervisory timidity, due to recent strong earnings history of banks and financial service companies.

Politically motivated incentives to the housing markets through GSEs that fueled the early trends toward lax home mortgage underwriting standards.

Widespread fraud committed by largely unregulated mortgage market participants (e.g., mortgage loan originators and brokers)

This last point raises an important and ominous concern.

Has an ethical gap been exposed?

Is it possible to say, based on some very public evidence, that, as a society, our value systems have deteriorated markedly?

Workplace fraud and misbehaviors-ranging from deliberate misreporting of earnings of public companies to lying, cheating, bullying, and other hostile and disruptive actions-are undermining fundamental interpersonal, economic, and

workplace relationships.

Human interactions and relationships rely on trust.

And our collective behaviors seem to be systematically undermining that trust.

Ultimately, the question really is, how serious is this decline to our traditional business models and ways of conducting our lending business?

A credit view of the ethical lapse

The rise in unethical behaviors puts the spotlight on credit underwriting fundamentals, such as the "Character" component of the Cs of Credit.

If the overall business environment is deteriorating in terms of willful human lapses, we are certainly going to learn additional lessons of an unwanted and unfortunate nature relating to the Character of our borrowers.

Are these to be inevitable and unavoidable?

The subject of moral hazard is important for lenders to understand. It can permeate our own attitudes, our work cultures, and the collective economic outcomes.

This is no time to just hunker down and wait for the storm to pass.

**YOUR ASSIGNMENT:** I'd like to know what you think about the future that we face through the deteriorating standards of human conduct by market participants. What are appropriate individual responses to contain possible damage going forward? E-mail me or comment directly below.

Did you miss Ed's first column in this series? [Read it now](#)

- About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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