

MORAL HAZARD BECOMES A GRAY AREA, THOUGH IT SHOULDN'T BE

Age of strategic default makes the once-unthinkable apparently acceptable

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In the banking business, moral hazard used to be confined to old-fashioned dishonesty on the part of a customer or the shenanigans of a renegade banker.

Such risks continue, of course. There also appears to be an apparent resurgence of the old-fashioned kind to deal with, as well.

But there are some additional ones to consider. One is moral hazard, which just keeps coming back in revised forms.

Why do I bring this up now? If we are going to grow our portfolios in the future with decent business we have got to understand the various forms of moral hazard. While none are favorable to the bank, not all forms have the same negative ethical consequences.

But some forms go to the very basics of credit. So, we are reminded again that in many important ways the process of an

accurate assessment of the borrower's willingness to repay is largely unchanged.

Let's explore moral hazard in several of its facets.

Moral hazard: People behaving badly

Moral hazard, as that term has entered our general vocabulary, is an economic theory describing how a party insulated from risk will behave differently than were he fully exposed to the risk. This is the Too Big To Fail issue in banking and, if my memory serves me correctly, it first surfaced with the failure of Continental Illinois in the early 1980s.

Economists often cite as examples the behaviors of people who are covered by insurance compared to those who are not. For example, is a person fully insured against loss less likely to lock his car than one who is uninsured?

Another type of moral hazard that has come to prominence in the last few years is when an individual has as his primary motivation for specific actions an incentive payment that is unrelated to the risk of such actions to the firm. This is the "greed" that many commentators of the contemporary business scene ascribe to run-away compensation and incentive systems that make no fundamental sense to the fortunes of the firm other than to enrich the individual. Some lenders have been shown to work in environments where increased loan outstandings are incented with little or no correlation to increased risks absorbed by the bank on the types or sizes of the resulting loans.

It would be unusual to consider such activity unethical, though it is possible to imagine scenarios where it might be deemed so. For example, let's say the risks assumed in the portfolio were understood to be significant. But let's say they

are undertaken anyway as a primary consequence of the incentive. Then there is an unethical effect, by virtue of potential harm to the stockholders of the bank. The potentially destructive scale of such activity became evident in the early phases of the current credit cycle slowdown.

In the drive for non-interest income, might some bank personnel strive to sell services without a sufficient justification or need by the customer?

I'm directly aware of the attitude of a platform officer for one of the mega banks who told me recently that he was expected to sell a specific fee generating service with a current quota of three in a week.

"If a customer is in my office and is even remotely a prospect, I give my pitch. After all, I've got three of these to sell by Friday and this person is next." This strikes me as unethical without some objective indication of need or utility by the customer.

Apparently, morality is optional

Then there's unethical activity done the "old fashioned way." A current manifestation of customer moral hazard is strategic defaults. This is where a borrowing customer, significantly underwater on his residential mortgage loan, simply defaults for reasons of convenience or one-sided advantage.

No matter that the borrower signed a long-term note and mortgage with the lender. The current deal no longer is beneficial to the borrower, so he simply defaults and walks away, leaving the bank to absorb a loss and liquidate the collateral. While it's not known precisely how many presently delinquent residential mortgage loans represent the new breed of strategic defaults, the number is believed to be substantial and growing.

Of course this isn't necessarily the end of the story. Increasingly, banks are pursuing deficiencies against borrowers that can be extremely problematic and possibly force the borrower into personal bankruptcy for relief from the debt.

Another area of concern is lender liability. This is a growing area of the plaintiffs' bar where borrowers are trying to stave off the impacts of foreclosure on business assets by the lender. What starts off as an attempt to delay collateral liquidation at distressed market prices often becomes a full-fledged attempt by the borrower to relieve himself of the obligations to repay. We'll explore this growing phenomenon and some of its consequences in coming columns.

Breakdown in responsibility

What's behind all this? It is a direct consequence of an attitude increasingly prevalent in society of a lack of responsibility for one's obligations.

I'm not referring to a renegotiating of terms of a loan so much as an attempted repudiation of the debt. It falls squarely into the category of moral hazard though to those of us who have been in the business for a while will simply refer to it as the "first C of Credit."

Collateral is no substitute for deficient character.

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.

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