The Role of Moral Hazard and Incentives in the Investment Banking Industry Prior to the Great Recession of 2008.

Abstract This paper presents an analysis of the role of financial incentives and moral hazard among investment banks leading up to the 2008 financial crisis. The paper argues that the lack of criminal prosecutions of key financial executives has been a key factor in creating moral hazard. Five years after the Great Recession ended in the U.S. the financial services industry continues to suffer from a crisis of trust with society.

Keywords: CSR, financial incentives, moral hazard, financial crisis, financial services industry, society.

Introduction

No other economic event, in recent memory, has provoked such profound self-examination in the U.S. of the ethical behavior of some of our most revered financial institutions than the 2008 financial crisis. From a business and society perspective, the behavior of firms in the financial service sector has damaged confidence in society about the ethical integrity of the financial system (CBS/NYT, 2013). We are now in an excellent position, thanks to details emerging from hundreds of civil lawsuits, to reflect on the causes of economic collapse, and to assess the lessons learned (Ferguson, 2012). Much of the post-mortem analysis of the crisis in the popular press e.g., (Reckard & Hamilton, 2014) and even in academic journals e.g., (Boddy, 2011) offers up moral assessments of various parties to the crisis. Our focus, eschews such analysis, to concentrate on more managerially relevant factors, such as the role of incentives and moral hazard among investment banks.

We organize the paper as follows: we begin by defining the key terms in our analysis - incentives, and moral hazard. Next, we apply these concepts to the role of investment banks leading up to the crisis.

Incentives/Punishments

The Board of Governors of the Federal Reserve System has identified risk-taking incentives, provided by incentive compensation arrangements in the financial services industry, as a key contributing factor to the financial crisis (Board of Governors of the Federal Reserve System, 2011). The widespread acceptance of the Anglo-Saxon shareholder model within the financial services industry, with its emphasis on the principal-agent problem of alligning incentive compensation with share price performance, was the moral and philosophical basis for such compensation practices (Quinn & Jones, 1995). In response to the crisis, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010. Among the Act's many provisions are new rules for incentive compensation. A large body of research in behavioral economics supports the view that proper alignment of incentives with a decision making environment can be a powerful way to induce certain behaviors (Kamenica, 2012).

Moral Hazard

Moral hazard refers to a situation in which an individual or an institution is more likely to take risks because the costs that could result will not be borne by the pary taking the risks (Dembe & Boden, 2000). Frequently, moral hazard occurs when there is information assymetry, a situation in which a party in a transaction has more information than another, and one party is insulated from the negative consequences of the risk (Krugman, 2009). In the context of the financial crisis, a moral hazard exits if a financial institution knows it is protected by a lender of last resort (government), and as a result, engages in riskier investments because it believes losses will be borne by someone else (Stiglitz, 2010). One peculiar aspect of moral hazard during the financial crisis of 2008 was the absence of criminal presecution of organizations or individuals for criminal behavior. Instead, the "punishment" was borne by way of financial penalties, payed out by organizations, at the cost of their shareholders (Ferguson, 2012).

Investment Banks

Critical reviews of the corporate social responsibility (CSR) literature have called for more desciptive research on how firms' roles in society are shaped in the interactions between firms and their stakeholders (Griffin, 2000). We address these roles by examining a number of questions. Why did investment banks so aggressively incentivise unethical, and sometimes, fraudulent behavior for their partners, the mortgage origination companies? Why would they seek loans that would have a high probability of failing? Was this a simple case of information assymetry whereby only the mortgage origination companies truly knew the poor quality of their home loans? Answers to these questions are necessary before we can understand the role of CSR in the financial services sector.

The role of incentives at investment banks was more complex than the case at the mortgage origination companies. First, there was at least an implicit assumption that investment banks had a fiduciary duty to act in the best interest of their customers and counter parties. Second, some investment banks were so big, and so integrated into the global financial system, that their failure posed the threat of systemic global financial collapse. In other words, they were "too big to fail".

Subprime home loans had higher interest yields and therefore could be packaged and sold more easily to institutional investors, so long as they continued to receive AAA, highest quality investment grade from the credit ratings agencies (CRA). Investment banks rarely held onto these collateralized debt obligations (CDOs) for longer than one to two months, before offloading them onto investors. Consequently, their risk was limited to this brief holding period. Investment banks had an incentive to source subprime loans over prime, and to pass the economic incentives down the securitization food chain. Evidence from civil lawsuits shows that internal investigations at investment banks revealed the extent of the problem with the quality of loans sourced, and that many loans clearly violated their own internal risk standards. When given a choice to reject these mortgages, or ignore their internal standards, investment banks invariably chose the latter (Ferguson, 2012, p.100).

Stockbrokers have a legal and ethical requirement to recommend only “suitable” investments to their customers, but contrary to popularly held beliefs prior to the crisis, most brokers do not have a stricter, legal fiduciary duty to their customers (Angel & McCabe, 2013). This was but one of many examples of information assymetry that existed between agents of investment banks and customers that bought CDOs. The information assymetry created a moral hazard for the investment banks’ agents since they were insulated from civil lawsuits based on alledged violations of fiduciary duty to investors. Brokerage firms often have numerous conflicts of interest with their customers in that products that pay the highest commissions may not be the best ones for their customers. Comissions create powerful incentives for the entire securitization food chain, but at the same time produce conflicts of interest – a type of ethical pollution. It is doubtful that most customers are aware of the extent of these conflicts of interests thus creating a classic assymetry of information. Given that the CDO market is more complex and less transparent than the equity market, the information assymetry works against efficient markets.

A second issue of incentives concerns the role of executive compensation. Many believe that excessive executive compensation and flawed incentive compensation practices can at least be partly blamed for the imprudent risk-taking that helped spark the economic crisis (Grant Thornton, 2014). The bonus culture mentality of the investment banks was born out of an attempt to address the age-old principal-agent problem. To align compensation of agents (executives) more directly with the interests of principals (shareholders), bonuses were used to reward executives for actions that maximised profitability. This is standard practice in corporate America. The incentive problem at investment banks however was the mis-aligned timing of incentives versus performance; cash bonuses were awarded based on short-term profits, but there were no penalties for long-term losses. Consider the basic bet; you make an extra $10 million a year by making high risk, high reward bets, but you put your financial institution at risk. If the institution fails, shareholders pay the bill. If your institution is too big to fail, tax payers pay the bill. The bet is frought with moral hazard. The problem with bonus-heavy incentives was particularly acute at investment banks. This was because many employees below the level of top executive positions were engaged in activities sufficiently risky to expose their institution to material financial loss e.g., traders with large position limits relative to the bank's overall risk tolerance (Board of Governors of the Federal Reserve System, 2011). Similarly, groups of emplyees who are subject to similar incentive-based compensation arrangements may, in the aggregate, expose a financial institution to a material amount of credit risk (note this was wisespead in the loan origination business).

The systemic risk posed by these incentive structures was described in 2005, by Raghuram Rajan, then the chief economist of the International Monetary Fund. He delivered a paper at the annual Jackson Hole Symposium, the most elite banking conference in the world. Rajan's paper focused on incentive structures that generated huge cash bonuses based on short-term profits, but which imposed no penalties for later losses. Rajan argued that these incentives encouraged bankers to take risks that might eventually destroy their own firms, or even the entire financial system (Raghuram, 2006). Raghuram later added “It's very easy to generate performance by taking on more risk.And so what you need to do is compensate for risk-adjusted performance. And that'swhere all the bodies are buried” (Raghuram, 2010).

There have been a number of proposals to address the incentive problem at investment banks. Among them include the need to (Board of Governors of the Federal Reserve System, 2011):

- Make risk adjustsments to the amount of incentive compensation award for an employee to take into account the risk the employees’ activities may pose to the organization.
- Defer a portion of the incentive compensation awards
- Identify key employees for whom incentive compensation arrangements may pose a threat to the organization’s safety.
- Involve risk management and control personnel when designing incentive compensation arrangements

Perhaps a more radical approach to executive compensation is warranted in light of increasing evidence that the favored tools of regulators and shareholders – deferral and often complex long-term incentive structures – may not produce the hoped for results (PWC, 2012). A PWC survey of senior global executives in the financial services sectors shows that only a limited number of executives are motivated by highly leveraged and volatile pay packages. The same survey found that participants believed that pay is as much about fairness and recognition as it is about incentives. The exclusive focus on share price incentive models of executive compensation may potentially blind us to viable alternatives to organizing the relationship between the investment banking industry and society (Matten & Moon, 2008).

In sum, when one evaluates behavior in the investment bank sector, problematic incentives, moral hazard, and conflicts of interests (exacerbated by information assymetries) appear to play a large role in executive decision making.

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