MORAL HAZARD AND AGENT – PRINCIPAL ISSUES IN CORPORATE FINANCE

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WHAT IS "MORAL HAZARD" ?

THE TERM HAS ITS ORIGIN IN INSURANCE INDUSTRY BUT THESE DAYS IT IS WIDELY USED IN CORPORATE FINANCE. IN SIMPLE WORDS, *ANY SITUATION IN WHICH ONE PERSON MAKES THE DECISION ABOUT HOW MUCH RISK TO TAKE, WHILE SOMEONE ELSE BEARS THE COST IF THINGS DON'T GO WELL.*

When Does It Arise ?

- ✓WHEN THERE IS INFORMATION ASYMMETRY(INEQUALITY)- ALL THE PARTIES DON'T HAVE THE SAME INFORMATION
- ✓ WHEN THERE IS A POSSIBILITY THAT ONE PARTY TO AN AGREEMENT HAS AN INCENTIVE TO TAKE ACTIONS THAT MAY HARM THE OTHER PARTY.
- ✓ SUCH ACTIONS ARE NOT OBSERVABLE.

MH

- Moral Hazard arises because one individual or institution **does not take the full consequences** and responsibilities of its actions, and therefore has a tendency to **act less carefully** than it otherwise would, leaving another party to hold some responsibility for the consequences of those actions.

MH

- I have insured my car fully so..I may be less cautious about locking my car…driving recklessly….. because the negative consequences of vehicle theft are now (partially) the responsibility of the insurance company.

MH

- e.g. The mutual fund managers ideally should invest funds so as not only to reap greater returns but also to subsequently pass them on to the investors. But they can invest the funds irresponsibly and selfishly thereby jeopardizing the financial interest of the investors.

MH

- Also a reason why the Indian Government did not bail out Kingfisher Airlines. This would set a bad precedent and in future other airlines may begin to act irresponsibly thinking that if things don’t work out well, they have the government to fall back on.

MH

- Sales Commission creates Moral Hazard because people get paid for SHORT-TERM RESULTS regardless of WHAT IS GOOD FOR THE COMPANY OR THE CUSTOMER

  e.g. Max NY Life Insurance Ad

MH

- **The US sub-prime crisis** can be the worst example of Moral Hazard. The loan managers of the banks resorted to haphazard lending …to most undeserving borrowers. …simply because their commission depended on the loans financed. These shoddy borrowers were in no position to repay !

MORAL HAZARD IN EQUITIES

Moral Hazard in Equity Contracts:
(the **Principal-Agent Problem**)

- Result of clear partition between Shareholders (*principals*) and Managers (*agents*)
- Managers act in their own rather than stockholders' interest because all the actions of agents are not monitored or observable e.g. sub-optimal decisions/extravagant behaviour

PRINCIPAL-AGENT

- Suppose I become a silent partner in a Pizza Outlet providing 90% of the equity capital i.e. Rs. 9,00,000. The other owner, XY,provides the remaining Rs. 1,00,000 and will act as the manager. If XY works hard, the outlet will make Rs.20,00,000 annually after expenses, and so I am entitled to Rs. 18,00,000 of it.

PRINCIPAL-AGENT

- However, XY doesn’t really value the Rs. 1,00,000 (his part), so he runs outlet irresponsibly like he does not put in efforts to augment sales…or shuts down the shop early or doesn’t bother about the customer satisfaction or even takes out his own “profit” which he thinks accrues to him, because of **unobservable actions or lack of proper monitoring of the agent** by the principal.

MH IN DEBT CONTRACT

- When the BORROWER has incentives to invest in riskier projects than the LENDER would like

  e.g. Mutual Funds
- When the BORROWER lends money to a third party at much higher rate of interest involving high risk WITHOUT the knowledge of the LENDER

  (it is rampant)
- When the BORROWER has malafide intension of not returning the money to the LENDER

  e.g. Banks sometimes suffer Bad Accounts because of Agricultural loans

MH & AUDIT

- Auditors may dish out favourable opinions/ judgments to retain audit business (in process the shareholders to whom the auditors are reporting, are taken for a ride)
- Auditors can actually window-dress the accounts of a company e.g. Satyam Ltd. & PwC.
- Auditors can charge hefty fees to validate certain transactions of dubious nature about which the shareholders would never know –conjuring up of fake documents etc.

EX-ANTE & EX-POST MORAL HAZARD

- If a finance manager makes reckless decisions knowing full well that he is not going to bear the consequences, is an ***ex-ante*** moral hazard.
- The manager wrongly projecting poor performance in spite of good financial results is an ***ex-post*** moral hazard.

MH & ADVERSE SELECTION

- ADVERSE SELECTION –ANOTHER INFORMATION ASYMMETRY PROBLEM
- AS OCCURS BEFORE THE CONTRACT IS FINALISED & MH OCCURS AFTER THE CONTRACT IS FINALISED

e.g. I get my car fully insured without revealing its actual condition…or health insurance hiding health related problems THAT IS ADVERSE SELECTION

e.g. I start driving my car recklessly after getting it insured..or get careless with my health is MORAL HAZARD

MH & AS

e.g. an investor deliberately invests money in a venture which he knows is doomed to failure to gain control over it/to hijack it later on- Adverse Selection

e.g. the same investor dictating terms to the borrower /interfering in an unjustified way/ refusing to provide sustained finance - Moral Hazard

REMEDIES TO MH

- ✓ MONITORING/OVERSIGHT OF AGENT (MISTRUST)
- ✓ GOVERNMENT REGULATION
- ✓ TRANSPARENCY/INFO. DISSEMINATION (NO UPPER HAND FOR INFO.)
- ✓ ATTACH SUBSTANTIAL VESTED INTEREST OF AGENT (FOLLOW UP)
- ✓ PRINCIPALS TO SECOND OR TO NOT SECOND DECISIONS OF AGENT (VETO) (No absolute power, it corrupts)

MORAL HAZARD

"In The History Of The World, No One Has Ever Washed a Rented Car"

- LAWRENCE SUMMERS


THANK YOU