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Systemic Moral Hazard Beneath The Financial Crisis

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The financial crisis in 2008 is the greatest economic recession since the "Great Depression of the 1930s." The federal government has pumped $700 billion dollars into the financial market to save the biggest banks from collapsing.[1] Five years after the event, stock markets are hitting new highs and well-healed.[2] Investors are cheering for the recovery of the United States economy.[3] It is important to investigate the root causes of this failure of the capital markets.

Many have observed that the sudden collapse of the United States housing market and the increasing number of unqualified subprime mortgages are the main cause of this economic failure.[4] Regulatory responses and reforms were requested right after the crisis occurred, as in previous market upheavals where we asked ourselves how better regulation could have stopped the market catastrophe and prevented the next one.[5] I argue that there is an inherent and systematic moral hazard in our financial systems, where excessive risk-taking has been consistently allowed and even to some extent incentivized. Until these moral hazards are eradicated or cured, our financial system will always face the risk of another financial crisis.[6] In this essay, I will discuss two systematic moral hazards, namely the incentive to take excessive risk and the incentive to underestimate risk. They are prevalent in our financial systems.[7] More importantly, it is crucial to

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[1] John B. Taylor, *How Government Created the Financial Crisis*, WALL ST. J. (Feb. 9, 2009 12:01 AM), http://online.wsj.com/news/articles/SB123414310280561945.

[2] THE ASSOC. PRESS, *S.&P. Hits New High as Market's Focus Shifts*, N.Y. TIMES, Oct. 18, 2013, at B8.

[3] Johnathan Cheng, *Stocks Hit New Highs*, WALL ST. J. (April 2, 2013 4:28 PM), http://online.wsj.com/news/articles/SB10001424127887323296504578398053061816998.

[4] Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, INDIANA L. J., 215 (2013).

[5] Eilís Ferran, THE REGULATORY AFTERMATH OF THE GLOBAL FINANCIAL CRISIS, 3-4 (Cambridge University Press) (2012).

[6] Kevin Dowd, *Moral Hazard and the Financial Crisis*, 29 CATO J., 163 (2009).

[7] Sanjay Sanghoee, *Greed and Punishment: Criminalize Moral Hazard to Fix Wall Street*, HUFF POST (Jan. 15, 2013 12:42 PM), http://www.huffingtonpost.com/sanjay-sanghoee/greed-and-punishment-wall-street_b_2459120.html.

understand what can be done in the current model to prevent the next financial turmoil from occurring.[8]

In Part I of this essay, I describe the relevant features of the financial crisis in 2008 and the more recent "London Whale" scandal. In Part II, I describe the regulatory responses crafted after the economic failure as well as the executive compensation issue under the current system. In Part III, I discuss the incentive to take excessive risk and the incentive to underestimate risk system moral hazards in detail and how they have led us into financial turmoil. In Part IV, I endorse moral reform as a more sustainable solution to the moral hazard defect in our system.

I. THE FINANCIAL CRISIS IN 2008 AND THE "LONDON WHALE"

The financial crisis of 2008 commenced with the bursting of United States housing bubble that reached its apex in 2006.[9] Securities and financial instruments closely related to United States real estate markets started to plummet since 2006. Soon after, the broader financial market collapsed and the credit market came to a liquidity halt.[10] The financial crisis was proximately triggered by flawed economic policies that encouraged home ownership among people who could not afford it without greater assistance than was given. Assistance included easy access to loans for subprime borrowers, enlargements of loan incentives with particularly favorable initial terms,

[8] Niko Lusiani, *Accountability, Not Austerity, Can Help Prevent Next Financial Crisis*, June 24, 2013, http://www.rightingfinance.org/?p=462.
[9] Shawn Tully, *Welcome to the Dead Zone*, CNN MONEY (May 5, 2006 12:14 PM), http://money.cnn.com/2006/05/03/news/economy/realestateguide_fortune/.
[10] Philip E. Strahan, *Liquidity Risk and Credit in the Financial Crisis*, FED. RES. BANK OF S.F. POST, May 14, 2012, http://www.frbsf.org/economic-research/publications/economic-letter/2012/may/liquidity-risk-credit-financial-crisis/.

decreased fees for unwarranted loans band excessive confidence in rising real estate prices communicated to borrowers.

The federal government has a long-standing desire to expand home ownership, particularly to low-income households. To facilitate this objective, government-sponsored mortgage enterprises (GSE), such as Fannie Mae and Freddie Mac, were established in the 1930s and the 1970s. To that end, GSE bears the implicit backing of the government's full faith and credit. Since the early 1990s, in order to effectuate the goal of increasing home ownership, the government has imposed "affordable housing quotas" on GSE, which was encouraged and required to hold a huge portfolio of subprime mortgages.[11] This resulted in a lowering of mortgage underwriting standards and contributed significantly to the disarray of subprime mortgage market and the breakdown of the housing sector.[12] As banks gave out more loans to potential home owners, housing prices began to rise accordingly.

Before the crisis, a steady and substantial influx of "hot" money from emerging markets flowed into American financial system. Coupled with the long-standing low interest rates set by the Federal Reserve, the ease and relative low cost of obtaining funds fueled the housing and credit bubble, building up consumers' debt burden.[13] As part of the housing and credit booms, the number of financial instruments, such as mortgage-

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[11] Daniel Mitchell, *What to Do with Fannie and Freddie?*, L.A. TIMES (Oct. 16, 2008), http://www.latimes.com/news/opinion/la-oew-mitchell-abromowitz16-2008oct16,0,225574.story#axzz2lFdWjN8P.

[12] Laurence Wilse-Samson, *The Subprime Mortgage Crisis: Underwriting Standards, Loan Modifications and Securitization*, http://www.columbia.edu/~lhw2110/Subprime_survey_Samson.pdf

[13] Lawrence H. White, *Housing Finance and the 2008 Financial Crisis*, CATO INST., August 2009, http://www.downsizinggovernment.org/hud/housing-finance-2008-financial-crisis

backed securities (MBS) and collateralized debt obligations (CDOs), which based their value on mortgage payments and housing prices, significantly increased.

As housing prices declined in 2007, major global financial institutions that had borrowed and invested heavily in subprime MBS and CDO reported significant losses. Traditionally, financial institutions profit from engaging in trading activities, which are heavily leveraged and requires short-term external financing. Banks proceed from matching lower-cost capital with higher-yielding investments. Therefore, the ability to acquire short-term financing is a lifeline for banks' operation. Unfortunately, in the case of Bear Sterns, when the subprime mortgage meltdown started to surface, Bear was compelled to recognize significant losses on the Mortgage Backed Securities (MBS) held in its trading portfolio. The decline in the firm's collateral value prompted its lenders to require more liquid collaterals, instead of the illiquid collaterals it was used to, which, in turn, forced Bear to liquidate more MBS and pressure the portfolio's market value further. Consequently, due to the uncertainty concerned customers started to withdraw or close their accounts due to the uncertainty. This further reduced Bear's ability to sustain a business and eventually pushed the firm into insolvency.

History repeats itself. As the memory of the financial crisis was slowly fading for many, four years after the financial crisis in 2008, it was reported that a rogue trader for JPMorgan Chase & Co. placed excessively heavy bets against positions held by other branches of the bank as well as other counter parties. A loss of $2 billion was initially reported by the firm for these trades. Subsequently, $5 billion additional losses were accounted in relation to the trades. A spokesman for the firm predicted total losses could be in excess of $7 billion.[14] After the unveiling of the event, it was discovered that the trader has purposely concealed the losses when it was first discovered and corporate risk governance failed to discover the defect.[15]

II. REGULATORY RESPONSE AFTER THE FINANCIAL CRISIS

In the wake of the crisis in 2008, the immediate question for policy makers was how to respond to the financial meltdown. The United States government responded to the crisis with unprecedented fiscal stimulus, monetary policy expansion and institutional bailouts. Congress enacted the Emergency Economic Stabilization Act, which implemented the Troubled Asset Relief Program (TARP) to provide the nation's failing financial institutions with a $700 billion emergency bailout.

Following the massive scope of government bailouts, legal experts and law makers called for regulatory solutions aimed at mitigating the impact of the current crisis and preventing recurrences.[16] Regulators and legislators are considering actions regarding "lending practices, bankruptcy protection, tax policies, affordable housing, credit counseling, education, and the licensing and qualifications of lenders."[17] Addressing each of these topics, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was signed into law by President Obama in July 2010. Dodd-Frank enhances authorities for the Federal Reserve to wind-down "too big to fail" institutions safely, safeguards taxpayers from financial institutions' losses by applying losses first to the

[14] Jessica Silver-Greenberg, *New Fraud Inquiry as JPMorgan's Loss Mounts*, http://dealbook.nytimes.com/2012/07/13/jpmorgan-says-traders-obscured-losses-in-first-quarter/?_r=0
[15] David Henry, *Analysis: JPMorgan to be haunted by change in risk model*, REUTERS (May 18, 2012 5:13PM), http://www.reuters.com/article/2012/05/18/us-jpmorgan-risk-idUSBRE84H15120120518
[16] JEC October Subprime Report, http://www.jec.senate.gov/public/?a=Files.Serve&File_id=148eaf7c-ee62-42f0-b215-006db6a11d65/Documents/Reports/10.25.07OctoberSubprimeReport.pdf
[17] *Id.*

firm's investors and by including the creation of a pool funded by the largest financial institutions, requires stronger capital and liquidity positions for financial firms and related regulatory authorities, and exercises greater control over executive compensation.[18] Among provisions in Dodd-Frank, the Volcker rule and the executive compensation provision have the most prominent effect on the financial system.

A. Volcker Rule

The Volcker Rule is a specific section of the Dodd–Frank Wall Street Reform and Consumer Protection Act originally devised to restrict American banks from making certain kinds of speculative investments which did not benefit their customers but played a key role in the financial crisis.[19] The rule prohibits banks from making investment bets with their own money.[20] The rule also bans proprietary trading by commercial banks, whereby deposits are used to trade on the bank's own accounts.[21] Wall Street banks were blamed for accumulating an unwarranted amount of risk and unfair business practices due to the inability of regulators to oversee their complex financial instruments and activities properly. The Volcker rule aims to protect individuals by creating a more transparent financial regulation and oversight framework to prevent banks from gambling on their

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[18] Timothy Geithner and Lawrence Summers, *A New Financial Foundation*, http://www.washingtonpost.com/wp-dyn/content/article/2009/06/14/AR2009061402443_pf.html

[19] David Cho and Binyamin Appelbaum, *Obama's 'Volcker Rule' shifts power away from Geithner*, THE WASHINGTON POST, February 13, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/01/21/AR2010012104935.html

[20] Scott Patterson and Deborah Solomon, *Volcker Rule to Curb Bank Trading Proves Hard to Write*, WALL ST. J. (Sept. 10, 2013 7:55 PM), http://online.wsj.com/news/articles/SB10001424127887323838204579000623890621830

[21] Floyd Norris, *Bank Rules That Serve Two Masters*, N.Y. TIMES, Oct. 14, 2011, at B1.

own account with money that taxpayers insure; consequently risks can be controlled with greater ease and visibility.[22]

Advocates of the Volcker rule and Dodd-Frank generally praised them as milestones in legislation because their purpose is to mitigate the probability and scale of future financial panics, end taxpayer bailouts of Wall Street, and boost taxpayer protection.[23] On the other hand, critics argued that the Volcker rule did not punish Wall Street enough for instigating the panic.[24] More importantly, it was argued that "the rule amounted to a vast expansion of government control over the financial sector without addressing the real causes of the financial panic, ending too-big-to-fail or addressing the continuing public assistance to or moral hazards caused by Fannie Mae and Freddie Mac."[25]

Others also argued that the rule did not simplify American regulatory infrastructure or does not improve cross-border coordination, but instead created an even more complicated structure that is difficult to be compliant with and increased the risks of regulatory arbitrage and inefficiency.[26] In addition, the Volcker Rule is intended to regulate proprietary trading and exempt principal investments from regulation.[27] In other words, the moral hazard within our financial system can still drive excessive risk-taking in principal investment, such as the toxic real estate investment the Lehman Brothers

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[22] Jesse Eisinger, *Volcker Rule Gets Murky Treatment*, N.Y. TIMES (APR. 18, 2012, 12:00 PM), http://dealbook.nytimes.com/2012/04/18/interpretation-of-volcker-rule-that-muddies-the-intent-of-congress/?_r=0.

[23] Brady Dennis, *Congress Passes Financial Reform Bill*, THE WASHINGTON POST, July 16, 2010, www.washingtonpost.com/wpdyn/content/article/2010/07/15/AR2010071500464_pf.html.

[24] *Id.*

[25] *Id.*

[26] Michael Helfer, *Regulatory Reform Overview – What's Next?*, at SIFMA Regulatory Reform Summit in New York City, July 15, 2010.

[27] John C. Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV., 1073 (2012).

pursued in 2006 and 2007 before the crisis without propriety trading involved.[28] Yet, the Volcker rule is not going to regulate such activities. The simple alternative solution for the Volcker rule is to cure the moral hazard of excessive risk-taking.

B. Executive Compensation

Not until the advent of the global crisis, executive compensation incentives were largely overlooked by global regulatory schemes.[29] There is now an increasing recognition that the manner in which bank managers are compensated should be central to banking regulation, and to the oversight of the overall financial system. While ill-designed compensation could lead to instability, excessive risk-taking, and gaming, the optimal response is not necessarily to swing to the other extreme and curb all risk-taking. A well-designed compensation contract should be multi-pronged rather than focused solely on bonus and equity. Along with deposit insurance premiums that are sensitive to bank executives' incentives, executive pay package could help achieve more effective banking regulation-one that does the best job of guaranteeing the stability of the banking system.

Many have accused excessive risk-takings by bank executives of facilitating the crisis.[30] The public was outraged by the size of the pay packages of executives at failed financial institutions. For instance, much attention has been directed to the large bonuses for Merrill Lynch former CEO, John Thain at the time Bank of America assumed control of Merrill. Thain was identified of earning a total compensation of $83,785,021, which

[28] *Id.* at 1074.
[29] Michael Faulkender, *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms*, 22 J. OF APPLIED CORP. FIN., 107.
[30] Victoria McGrane, *Bernanke: Regulators Have Taken Steps to Limit Excessive Risk Taking.*, http://blogs.wsj.com/economics/2013/11/08/bernanke-regulators-have-taken-steps-to-limit-excessive-risk-taking/.

included a base salary of $750,000, a cash bonus of $15,000,000, stock grants of $33,013,151, and options grants of $35,017,421.[31] In terms of compensation structure, Thain, like many other executives, received pay in the form of equity or options. To the extent the shareholders of levered institutions benefit from granting executives stock or options and aligning them with shareholders they also may suffer from the unintended could have the unintended encouragement of executives to take on additional risks.[32]

Aside from the ill-structured executive compensation plans, the predatory lending practice many banks, including Countrywide Financial, were involved also greatly contributed to the financial system failure. Predatory lending is the deceptive, or fraudulent practices of mortgage lenders during the loan origination process, where unfair and abusive loan terms are imposed on borrowers.[33] Predatory lending typically involves borrowings backed by collaterals. Mortgage originators were accused of tricking borrowers into believing that the borrower's ability to pay is greater than it actually is. Once the borrower defaults on the loan as mortgage originators have already projected, the lender can recuperate or foreclose the collateral and profit from the sale of the collateral.[34]

A well-designed executive compensation package can serve as a key mechanism for corporate governance, which could align executives' investment and financing

[31] Michael Kitchen, *Merrill's Thain was highest-paid CEO in 2007*, http://www.marketwatch.com/story/merrill-lynchs-thain-tops-ceo-pay-ranking-for-2007-report.
[32] Michael Faulkender, *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms*, 22 J. OF APPLIED CORP. FIN., 107.
[33] Office of Inspector General, *Challenges and FDIC Efforts Related to Predatory Lending*, Report No. 06-011, June 2006.
[34] Mike Hudson and E. Scott Reckard, Workers Say Lender Ran 'Boiler Rooms', L.A. Times, February 4, 2005, http://www.latimes.com/business/la-fi-ameriquest4feb0405,1,5202756.story#axzz2lFdWjN8P.

decision making with shareholder interests.[35] However, a flawed compensation scheme can lead to value destruction and excessive risk taking.[36] If executive compensation is tied to the company's short-term profits, it can lead can lead executives to pass over promising long-term investment opportunities in order to focus on short-term profit taking, which in turn boosts their short-term compensation. In addition, if public companies are over-valued by the financial market, compensation in the form of stock options may lead executive to focus on short-term earnings or, in some extreme cases, to manipulate earnings to justify the firm's current stock price, or sustain their compensation based on the stock price.[37]

In response to the crisis and public outcry, executive compensation has been a prominent target of regulators and policy makers of various financial markets. The United Kingdom Financial Services Authority now regulates both the structure of executive pay and the claw-back time period during which the incentive pay is distributed.[38]

In the United States, the SEC and the Federal Reserve have imposed "quantitative limits on the amount, structure, and timing of compensation payments to top-paid executives at companies receiving TARP funds.[39] Further expansion of pay control was contemplated as a part of Dodd-Frank. Particularly, Dodd-Frank regulates that "within

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[35] Michael Faulkender, *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms*, 22 J. OF APPLIED CORP. FIN., 108.
[36] Ben Bernanke, *Financial Regulation and Supervision after the Crisis: The Role of the Federal Reserve*, October 23, 2009, http://www.federalreserve.gov/newsevents/speech/bernanke20091023a.htm.
[37] Michael Faulkender, *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms*, 22 J. OF APPLIED CORP. FIN., 108.
[38] Jill Treanor, *Financial Services Authority vets banks' pay policies*, http://www.theguardian.com/business/2009/dec/13/banking-executive-pay-tax.
[39] Aaron Lucchetti, David Enrich and Joann S. Lublin, *Fed Hits Banks With Sweeping Pay Limits*, WALL ST. J. (Oct. 23, 2009 12:01 AM), http://online.wsj.com/news/articles/SB125623026446601619.

one year of enactment, the SEC must issue rules that direct the national securities exchanges and associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of the compensation sections."[40] Dodd-Frank's executive compensation provision also requires a public corporation to submit executive compensation to a shareholder vote at least once every three years.[41]

More prominently, under the provision, shareholders must be apprised of the relationship between executive compensation actually paid and the financial performance of the company.[42] The annual total compensation of the chief executive officer, or any equivalent position and the ratio of the amount of the medium of the annual total with the total CEO compensation must be disclosed to shareholders.[43] In addition, to ensure fairness, members of the Board of Director's Compensation Committee shall be an independent member of the board of directors, a compensation consultant or legal council, as provided by rules issued by the SEC.[44]

However, some argued that Dodd-Frank will contribute to legal uncertainties in the financial sector at least in the short-term.[45] The Act creates a generic framework, where many key issues to be resolved by implementing regulations are left out. According to Guynn, at least 243 new federal rule-makings are needed to implement its

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[40] Dodd–Frank Wall Street Reform and Consumer Protection Act (Enrolled Final Version – HR 4173), § 153(d) *THOMAS*, October 20, 2013.
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] H.R. 4173, § 951; amending the Securities Exchange Act of 1934 (15 U.S.C. § 78 et seq.) by inserting: SEC. 10C. Compensation Committees.
[45] *The Uncertainty Principle*, WALL ST. J. (July 14, 2010 12:01 AM), http://online.wsj.com/news/articles/SB10001424052748704288204575363162664835780.

provisions.[46] In the next phase of United States financial regulatory reform, Guynn argued that "regulators will face an intense period of rule-making for at least 18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty. The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted, and even then, many questions are likely to persist that will require consultation with the staff of the various agencies involved."[47]

The Dodd-Frank will not alter the fundamental shapes of the United States financial regulatory regime and it simply re-shuffles the alignment of the regulatory boxes.[48] The United States financial regulatory structure will remain the same and the regulatory reform effort might not be promising as it seems.[49]

III. DEFICIENCIES IN THE REGULATORY REFORM AND PROPOSED REGULATORY SOLUTION

Thus far, I have provided an overview of the financial crisis and regulatory responses afterwards. In this section, I will discuss in detail the deficiencies observed in the current regulatory reform and argue that the regulatory reform, such as Dodd-Frank, is inadequate and more involved reform is needed.[50]

A. Inadequacy of Government Oversight

[46] Randall D. Guynn, *The Financial Panic of 2008 and Financial Regulatory Reform*, http://blogs.law.harvard.edu/corpgov/2010/11/20/the-financial-panic-of-2008-and-financial-regulatory-reform/.
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] Gretchen Morgenson, *3,000 Pages of Financial Reform, but Still Not Enough*, N.Y. TIMES, May 30, 2010, at BU1.

Under Dodd-Frank, the Board of Governors of the Federal Reserve System would be "responsible for overall conditions of financial market stability."[51] Such responsibility is conducted via the collection of information, permitting the Board to evaluate "the risks present in the overall financial system."[52] Yet the regulation does not allow the Fed to intrude into the operations of individual firms but rather will emphasize systemic risks affecting the market as a whole.[53]

Additionally, it is argued that the creation of new regulators will not bring greater transparency or accountability to the regulatory process. The reform merges the Office of Thrift Supervision with the Office of the Comptroller of the Currency and the SEC with the CFTC. Disagreements between the two agencies will be refereed to the Financial Services Oversight Council, which would likely lead to slower decision-making. More importantly, the regulation reform fails to address the "too big to fail" issue. The largest banks of the nation are still intact with a huge concentration of capital and financial risks.

The Consumer Financial Protection Agency protects users and borrowers in the credit card and mortgage business.[54] Yet, the agency was not delegated the proper authority to regulate the mutual fund, hedge fund and private equity industries, which would also expose consumers to a great amount of financial risks. Therefore, we should

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[51] U.S. Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure (2008) at 144.
[52] *Id.*
[53] *Id.*
[54] Jean Eaglesham, *Warning Shot On Financial Protection*, WALL ST. J. (Feb. 9, 2011 12:01 AM), http://online.wsj.com/news/articles/SB10001424052748703507804576130370862263258.

look beyond the traditional shape of regulatory reform to prevent the next crisis from occurring.[55]

B. Proposed Regulatory Reform

Market participants advocate two forms of regulatory reforms.[56] First, minimum investment or co-investment should be required from asset managers. Before any investments are made, asset managers should contribute to a significant portion of the deal before investors' money is accepted. Second, we should impose legal, or in some cases criminal, sanctions against the primary decision-maker. The standard should be the "best practice" standard, which will encourage the corporate managers' to exercise their best judgment using information they possess at the moment of decision-making.

Circling back to the first recommended approach, if the asset manager bears the same amount of financial risk as the investors, he/she will conduct a higher level of due diligence and a greater level of risk management for his/her decision-making. The minimum investment threshold will offset the tendency to take excessive risk by counterbalancing moral hazard.[57]

I would defer to the legislature for the precise context of the minimum investment threshold. Assuming that every investor and every investment opportunity is different in nature, the design of appropriate incentive schemes requires a case-by-case analysis. However, we do not want to trump the nature of capitalism and free market by imposing

[55] Ross Levine, *Reform Lessons from the Recent Crisis*, Bank of International Settlement, http://www.bis.org/events/conf100624/levinepaper.pdf.
[56] Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV., 185 (2009).
[57] Ruth Sullivan, *Impetus for managers to invest in own funds*, FIN. TIMES (Jan. 9, 2011 9:06 AM), http://www.ft.com/intl/cms/s/0/19d17382-1a96-11e0-b100-00144feab49a.html#axzz2l3waOWKd.

rigid and tedious market regulations. The proposed regulation should eliminate the current incentive schemes giving asset managers an "upside only" perspective.

Some scholars also argued that the right approach for market reform is to provide market participants and consumers with adequate information to make sounds personal investment decisions. The suggested approach would require designated persons like the key decision-makers at banks, hedge funds, and other financial institutions to file a financial disclosure statement that reveals their stakes in their risk-taking decisions and how they may profit from them.

Legal and criminal sanctions are also argued to be a solution. Financial penalties for banks are no longer novelties. JPMorgan recently paid a hefty $13 billion penalty to settle with the United States government over Mortgage Backed Securities related legal disputes.[58] Since the beginning of 2010, Bank of America has paid about $45.87 billion in various settlement agreements.[59] For companies, severe financial sanctions might not always be feasible, since that would often result in significant job losses for lower-level workers who are not involved with high-level decision making.

As other criminal cases, to impose any criminal liabilities, the government must prove beyond a reasonable double the criminal intent. In the scenario of white collar crime, this is sometimes a difficult standard to meet. The recent collapse of MF Global is a good example of just how hard it will be to prove criminal violations. Former MF Global CEO Jon Corzine asked the United States District Court in Manhattan to dismiss

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[58] Tom Schoenberg, Dawn Kopecki, Hugh Son & Dakin Campbell, *JPMorgan Said to Reach Record $13 Billion U.S. Settlement*, BLOOMBERG (Oct. 20, 2013 1:27 AM), http://www.bloomberg.com/news/2013-10-19/jpmorgan-said-to-have-reached-13-billion-u-s-accord.html.

[59] *Bank of America's Settlement Tally*, WALL ST. J. (May 6, 2013 2:46 PM), http://blogs.wsj.com/moneybeat/2013/05/06/bank-of-americas-settlement-tally-an-update/.

regulators' charges related to more than $1 billion in customer money that went missing as the firm spiraled toward bankruptcy. He claimed that "there is no evidence demonstrating that Mr. Corzine knowingly directed unlawful conduct or acted without good faith."[60] Although, the district court dismissed this claim by stating that "Defendants' contentions would suggest that ... perhaps the debacle must have been the fateful work of supernatural forces, or else that the explanation for a spectacular multi-billion dollar crash of a global corporate giant is simply that 'stuff happens.'", it's interesting to see what happens in the appellate court.[61]

Recently, there have also been more criminal prosecutions for violations of the antifraud laws. In *U.S. v Rajaratnam*, hedge fund manager Raj Rajaratnam was found guilty on all 14 counts of conspiracy and securities fraud and sentenced to 11 years in prison.[62] Although the Dodd-Frank Act authorizes the United States Sentencing Commission to review sentencing guidelines for financial crimes to ensure they reflect the impact of the offenses.[63] Higher recommended sentences may result in greater punishments because the sentencing guidelines are not mandatory and judges have the liberty to deviate from the guideline in the sentencing, perhaps the recommended guideline may be used as a floor in severe cases.

However, without a significant shift in how our financial market works, mere regulations will not cure the systemic defects and moral hazards already deeply rooted in

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[60] *Corzine sued by CFTC over MF Global debacle*, http://money.cnn.com/2013/06/27/investing/mf-global-corzine/

[61] *Banks fail to win dismissal of MF Global lawsuit*, http://www.reuters.com/article/2013/11/12/us-mfglobal-lawsuit-idUSBRE9AB10L20131112

[62] U.S. v Rajaratnam, 719 F.3d 139 (2d Cir. Oct. 25, 2012).

[63] David Debold and Matthew Benjamin, *"Losing Ground" – In Search of a Remedy for the Overemphasis on Loss and Other Culpability Factors in the Sentencing Guidelines for Fraud and Theft*, 160 U.PA.L.REV., 142 (2011).

our system. Today, many financial executives escaped criminal liability even though their irresponsible decisions driven by greed and self-interest almost brought the financial system to the ground. Some traders lost their original posts. But they were awarded millions of dollars as their severance package, which an ordinary citizen could not make in his or her life time of working. As long as this compensation practice is not rectified, executives will continue taking the risky bets and put the system at risk.

The responsibility of protecting investors also falls on the trustees of the company. In a more recent case, New York State Supreme Court is close to struck a settlement deal between Bank of America and 22 mortgage securities investors, which will resolve Bank of America's legal liability for the one million loans made by Countrywide Financial and inherited by Bank of America.[64] The essence of this settlement goes to Bank of New York Mellon's role as the trustee charged with protecting all investors in the securities sold by Countrywide.[65] The result of this case will re-emphasize the duty trustees owe to asset-backed securities.

IV. SYSTEMIC MORAL HAZARD IN THE FINANCIAL SYSTEM

Moral hazard occurs when one party is responsible for the interests of another, yet has a conflicting incentive to prioritize his or her own interests above others.[66] Such moral hazards are pervasive in the financial system. Notably, the most prevalent forms of moral hazard is an incentive to take excessive risk or an incentive to understate the risk inherent in the transaction under consideration.

[64] Gretchen Morgenson, *Who Has Your Back? Hard to Tell*, N.Y. TIMES, Nov. 17, 2013, at BU1.
[65] *Id.*
[66] Dowd, *supra* note 6, at 147.

A. Incentive to Take Excessive Risk

Moral hazard arises when asset managers are not financially responsible for all of the consequences of their actions. Since in practice are no financial penalties are imposed for asset managers' wrongful investment managers' decisions and higher returns are generally associated with higher risks taken, asset managers have the incentive to take additional risk for additional returns.

This form of investor-asset manager relationship is inherent in the modern-day financial system. All the failed financial institutions, such as Lehman and Merrill Lynch share this type of relationship. For instance, Lehman Brothers accumulated excessively risky Collateral Debt Obligations (CDO) assets right before the collapse in 2008, where it clearly ignored various market signs of a potential housing market downturns. This outrageous behavior is driven by record high bonuses awarded to banking and investment banking executives in the years leading to the great burst.

Fee arrangements between investors and asset managers are frequently consisted of a fixed fee and a performance fee. The existence of a performance fee balances the equation. If a manager earns a fee based on assets under management, part of the value of the asset management relationship can be seen as the annuity that comes from the stream of fixed management fees.[67] A loss of capital reduces that performance income stream and therefore reduces the value of the annuity.[68]

The loss of the performance income can counterbalance the additional value that comes from taking greater risk. Likewise, investors may insist that managers place a

[67] William N. Goetzmann, Jonathan E. Ingersoll, Jr. & Stephen A. Ross, *High-Water Marks and Hedge Fund Management Contracts*, 58 J. FIN. 1685, 1686 (2003).
[68] *Id.*

significant amount of personal capital at risk in the same pool as the client's. However, in order for this theory to work, the rewards of increased risk-taking cannot significantly outweigh the costs, as happened in the years preceding the crash.

John C. Coffee also argued that incentive-based compensation at financial institutions focused on short-term results instead of longer-term risks is one of the systemic moral hazards prevalent in our system.[69] Executives in charge of many decision-makings at the "too big to fail" financial institution are rewarded generously in their annual bonus if they close a sufficient number of deals for the given year. However, the financial consequence of the deal won't be apparent until years later when these executives who made the initial decisions and reaped the generous bonus have either left the institution or moved on to "too big to fail" institutions.[70] In short, excessive executive compensation leads to excessive risk-taking, and eventually leads to a systemic moral hazard.

B. Incentive to Understate Risk

Wall Street tends to undervalue or deliberately conceal the risks associated with prospective transactions. In the case of the "London Whale," early indicators of potential risky bets and losses were clear. A cross line of business (LOB) governance monitoring function should have detected this defect quickly. Arguably the monitoring was overridden.

The tendency to understate risks was also demonstrated in the market for mortgage-related assets. Mortgage bank officers performing mortgage origination are

[69] Coffee, *supra* note 27, at 1047.
[70] *Id.*

compensated based on the volume of mortgages they produce. The more mortgages they originate, the higher the compensation they receive. Neither the mortgage bank, such as Countrywide Financial, nor any of its agents has any incentive to be concerned with the quality of the loans they originate so long as they can package and resell these mortgage loans into mortgage pools. Pool sponsors—investment firms whose business it is to structure investment pools, securitize them, and sell the resulting tranches of securities to investors—were focused on closing transactions.[71]

Faith in the market's ability to analyze and measure risk was firmly held by many key contributors to the financial crisis. They had much to gain by taking credit risk and by erring on the side of understating the risks taken, betting on the other party's resources in exchange for potential lucrative personal gains. The bet was permitted to grow as risk control shriveled, thus learning only a façade of control over a disintegrated infrastructure. Downplaying mounting risk led us to the financial demise of the entire mortgage lending system.

V. PREVENTION OF THE NEXT FINANCIAL TURMOIL

So far, we have examined regulatory reforms after the crisis, and investigated the two inherent systemic moral hazards in our financial systems. Yet, the problem must be addressed by more ethical thinking and greater respect for virtues and intangible capital assets such as reputation and social capital. We need the yet-to-come moral reform that integrates the dehumanized world of finance and economics with the virtues of human good. Reexamining the financial crisis, we could easily identify a series of moral malfeasances, which includes lenders originating unqualified loans, homebuyers

[71] Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV., 214 (2009).

falsifying data on their mortgage application frequently at the prompt of mortgage originators, lenders misleading investors for the mortgage backed securities sold, and bankers creating complicated financial products designed to hide the true risks inherent in these instruments.

Dealing with the crisis, we turned to economists for economic policy deficiencies, mathematicians for financial model insufficiencies, law makers and legal experts for regulatory reforms. Yet as examined above, these experts cannot by themselves provide a sufficient solution to prevent the next crisis. Instead, we should seek intangible alternatives such as trust, honor, dignity, virtue, and the common good and emphasize their practical and moral important in re-establishing trust in the financial system.

A. Moral Virtue

Honesty and transparency are the centerpiece of moral virtue.[72] A bank can provide information in an honest and transparent fashion so that the stakeholders involved can easily obtain a good insight into the issues that are relevant for them. Transparency contributes to the trading party's decision-making by allowing them the fullest extent of information available. A lack of transparency enables the better-informed market party to exploit the other party's lack of information "by manipulating the price, quality or quantity in a manner that is hard to discern for the less well-informed market party."[73]

There is also the virtue of taking due care of the interests of clients. Clients' information should not be sold and used in other ways from the way it was initially

[72] Johan J. Graafland and Bert W. van de Ven, *The Credit Crisis and the Moral Responsibility of Professionals in Finance*, 103 J. OF BUS. ETHICS, 605–619 (2011).
[73] *Id.* at 623.

intended to be used. Banks should be responsible to ensure the client understands the nature and consequences of the contract she or he entered into. So something was indeed wrong with the behavior of many brokers, but this was not so much the intention to deceive clients as the lack of due care for their interests. Lack of due care for the interests of consumers was prevalent during the financial crisis. Mortgages originated by the banks and later sold to investors were mislabeled as to their quality. Consequently, investors were misinformed.

B. Human Dignity

The idea of human dignity encompasses the intrinsic worth inherent in all human beings. Human dignity forms the conceptual core of human rights and individuals are considered as intrinsically connected to the rest of society. The lack of respect for human dignity has led to many unethical business behaviors during the financial crisis. For example, "predatory lending" is the term used to describe the unfair, deceptive, or fraudulent practices imposed during the loan origination process. Unfair and abusive loan terms were routinely imposed on borrowers. The threat to human dignity associated with the financial crisis in consumer business transactions reveal the necessity for nurturing a greater awareness of moral consciences.

C. The Common Good

Common good is the good we have in common, under which the pursuit of human fulfillment, flourishing, and perfection by all in society.[74] It is the collection of collaborative efforts where society helps every member within it achieve each one's

[74] Dowd, *supra* note 6, at 149.

individual objective. Many unscrupulous behaviors during the financial crisis were contrary to the common good. For instance, executives took excessive risks for personal pecuniary gains at the expense of other taxpayers in the society.

CONCLUSION

As it is still fresh in memory, the economic scandals provide a unique opportunity for us to review and look back at the moral standards for market participants. As illustrated in this paper, the financial crisis was not an isolated event. It was triggered by years of distorted macroeconomic policies, faulty executive compensation structures, inadequate regulatory oversight and more importantly the inherent moral hazards – the incentive to take excessive risks and the incentive to understate risks, long existed in our financial systems.

Various measurements have been adopted since 2008 to contain the risks and prevent the next scandal from happening. Dodd-Frank was implemented to regulate lending practices, bankruptcy protection, tax policies, affordable housing, credit counseling, education, and the licensing and qualifications of lenders.

Yet, as illustrated, there are two main deficiencies within the Volcker rule and the executive compensation provision. The Volcker Rule is a vast expansion of government control over the financial sector without addressing the real causes of the financial panic. The rule also complicates American regulatory infrastructure or but does not improve cross-border coordination. The Volcker Rule and the executive compensation provision still does not remediate the incentive issue of excessive risk taking.

Therefore, to restore the trust society places in this sector of the economy and to reassert moral authority in the financial community and in consumer business transaction, we need to search beyond the regulatory arena for a solution. It is time for us to focus on the reputational capital and social capital at stake. Reputational and social capital are facilitated by refining our moral virtues, human dignity, and the common good. As the financial market is ever-changing, we will always be drafting statutes to deal with issues occurred. These statutes and regulations are hardly sufficient to prevent the next sin.

Increasing the stock of reputational and social capital, however, is more efficient and sustainable than legal and regulatory intervention. The moral reform will stay with society and not become obsolete or outdated. The moral reform will cure the failure of social responsibility, not only in the financial sector, but in the society as a whole. To this end, honesty and transparency are of crucial importance.

Banks ought to furnish accurate and transparent information to customers for their decision making. Due care of clients' interests should also be paid much attention. Banks should be responsible to ensure the client understands the nature and consequences of the contract she or he entered into. In addition, to nurture a greater awareness of moral consciences, human dignity associated with the financial crisis in consumer business transactions must be emphasized. Ultimately, the common good should be pursued using collaborative efforts where society helps every member within it achieve each one's individual objective for fulfillment, flourishing, and perfection by all in the society.

We should never forget about the moral degradation leading to the financial crisis, which abused the societal trust inherent in our interdependence and mutual responsibilities. To rebuild and restore the trust society delegates in the financial sector, it must emphasize the ethics of virtue, human dignity, and the philosophy of the common good.