Moral Hazards

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Ideas are the most ephemeral of things. By themselves, they pull no weight, they carry no water. No two people understand an idea in just the same way, and no two people explain it just the same way. When a person dies, her ideas die with her, unless she has communicated or recorded them.

And yet ideas have power; ideas can cause the broad and meandering current of history to change its course, to cut off some areas and water others. Ideas channel our perceptions and we see some things and don't see others because of our ideas about the way the world works. Ideas can have legs – and hands, and mouths.

Here is the story of an idea that almost brought the economy of this country, the largest economy in the world, to a complete meltdown. After a lot of damage was done, the day was finally saved by jettisoning this idea.

In February, PBS's news program Frontline did a very sober, clear-eyed account of the financial crisis of 2008 called "Inside the Meltdown," which followed the actions of Federal reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson. The program, which you can still watch online[1], focused on Paulson's wrestling with and finally abandoning this idea, the cherished conservative notion of moral hazard.

In the program, Joe Nocera of the New York Times describes the idea this way: "Moral Hazard poses the question: if you bail someone out of a problem they themselves caused, what incentive will they have the next time to avoid making the same mistake?"

Moral hazard has been an idea in economic analysis for centuries. It's often used in thinking about insurance. If I sell you a policy of insurance on your house, that may make you careless about turning off the stove, because you know that you can get the house rebuilt. If you have insurance on your car, you might be a careless driver because you know that insurance will pay for any damage you cause in an accident. If you have health insurance, you might continue risky behavior like smoking or eating the wrong foods because you know that you can go the hospital and get fixed and it won't cost you anything.

Now this idea is perfectly logical; the only problem is that in most of the areas it is applied by economists, real people don't behave that way. It reminds me of one of my favorite sayings from H.L. Mencken: for every stubborn, intractable problem, there is a solution which is simple, obvious – and wrong. Most people don't drive recklessly because they have insurance. Most people aren't careless about fires because they have fire insurance. Most people don't take risks with their health because they have good health coverage.

And yet the argument has had a lot of effect in certain circles. Malcolm Gladwell wrote an article in the New Yorker in 2005[2] showing how the concept of moral hazard was very influential in explaining why health care reform had never gotten off the ground in America. Why do you have a co-pay on your insurance policy? Why do you have to write a check to your doctor with each visit, after writing checks to your insurance company of the monthly premium? That system is set up to give you a personal stake in how much medical treatment you consume, and supposedly makes you more efficient. Gladwell's article cites many studies showing that it in fact does not make consumption more efficient.

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[1]http://www.pbs.org/wgbh/pages/frontline/meltdown/view/

[2]Gladwell, Malcolm "The Moral-Hazard Myth: The bad idea behind our failed health-care system." August 29, 2005

Moral hazard makes more sense in the financial sector. In the financial sector, risk means the chance that a debt will come due or an investment will not pan out. Now I'm no expert, but what I think I know is that fundamentally in investing there is a tradeoff between risk and reward. If I want a high return on my investment, I take the gamble that the investment will not pan out. If I want something safer, I accept a lower rate of return.

Now there is a public interest in finding investors to make risky investments. High tech companies, biotech companies, all these firms that are on the cutting edge in bringing us amazing things like GPS and cell phones and MRIs, all of them need venture capitalists who are willing to put money on the line. When a venture capitalist puts money on the line for a biotech startup, she takes the risk that this company's proposed product won't make it out of the lab. It is good that investors do this, it helps us all.

From what I read, the root of the economic crisis of 2008 is in the fact that investors and lenders wanted to have their cake and eat it too. They wanted to have the high rewards benefits of risky investments without exposure to the actual risks of those investments, and so they invented a kind of insurance, called credit default swaps. The way these things work is that if you have an investment in something risky, whether it is a startup company or securities based on subprime mortgages, you can buy from me a promise that I will pay you the full value of your investment if the investment goes bad.

In March of 2008, Ben Bernanke and Henry Paulson were faced with a crisis in confidence involving Bear Stearns, a giant investment bank on Wall Street. Paulson knew Wall Street; before he was Secretary of the Treasury, he had been CEO of Goldman Sachs, another giant investment bank. As a good member of the Bush administration, he believed in the free market, and free market principles, that is that markets operate best and in everyone's best interest by government keeping its hands off. And he believed in the theory of moral hazard: the market is most efficient when all actors must bear the consequences of their own actions. The system won't work unless troubled businesses are allowed to go under.

The problem staring Paulson in the face starting last March was that this idea of moral hazard had came into conflict with the very survival of the whole system. When Bear Stearns got in trouble, it became clear that it would do substantial damage to the whole financial system if it went down. It was too big to fail. Moral hazard theory only works on a working system; if the system itself dies, there are no actors to engage in moral hazards.

So when Bernanke worked out a deal in March to put up some federal money as a guarantee so that JP Morgan would buy Bear Stearns, Paulson was deeply troubled. He signed on to the deal, but he made sure that Bear Stearns got punished. Many of the employees of Bear Stearns held company stocks which had been used for bonuses and other compensation over the years. The stock had been trading in the twenties. JP Morgan was prepared to buy it for $4 per share. Paulson insisted that it only be bought at $2 per share. This was so that Bear Stearns employees not be rewarded for their mismanagement. He also tried to send a strong message to Wall Street: no more bailouts[3].

That was in March. In a speech in London in early July, Paulson was still a true believer; he said,

"For market discipline to be effective, it is imperative that market participants not have the expectation that lending from the Fed, or any other government support, is readily available. ... For market discipline to constrain risk effectively, financial institutions must be allowed to fail."

But reality had a way of catching up with Paulson's ideas. Shortly after saying these words, he was faced with the failure of the giant quasi-public companies, Fannie Mae and Freddie Mac. He set about trying to arrange a bailout. But since these entities started as government agencies, it wasn't such a bitter pill to swallow to have government money come to the rescue.

Then in early September, Lehman Brothers, heavily invested in securities based on subprime

[3]The $2 per share figure was later revised upward to $10 per share.

debt, started to founder. On September 9, its stock plunged 45%. On September 10, Lehman held a conference call with its investors trying to assure them that the firm was sound. But on September 11, JP Morgan made a demand on Lehman for additional $5 billion collateral, and the firm's computerized trading system froze. Hedge funds and other customers continued to pull their money out.

Paulson called an extraordinary weekend meeting of the heads of the major Wall Street investment firms, and told them they had to work out a rescue plan for Lehman, there would be no federal money as there had been with Bear Stearns. He drew a line in the sand, a line called moral hazard. Several other firms looked at buying Lehman, but wouldn't do it, and on Monday, Lehman was forced to file for bankruptcy.

That Monday, September 16, the markets took a nosedive and global credit came to a grinding halt. Then the insurance giant A.I.G., which was heavily invested in credit default swaps based on the bet that companies like Lehman would not go under, got into a fix and because credit was frozen, had no place to turn but the government. Bernanke arranged a two-year, $85 billion loan and took an 80% ownership share in the company, effectively nationalizing it. But Bernanke also realized more action was needed, and went to Paulson to persuade him that the federal government needed to bail out the whole financial system. The two of them went to Capitol Hill where they warned the leaders of Congress that a meltdown of the entire US financial system was imminent. This set in motion the $700 billion bailout called Tarp, and the rest, as they say, is history.

But a meltdown of Henry Paulson's commitment to the idea of moral hazard had already occurred. The idea of not rewarding risky behavior had to take a back seat to ensuring the survival of the stage on which all economic activity takes place.

The tragic irony in this story is that Paulson was closing the barn door after the horse was long gone. If insurance schemes encourage risky behavior, as the theory of moral hazard has it, then credit default swaps were the worst kind of moral hazard, and it was the credit default swaps on top of the subprime securities that had gotten the financial system into this mess. The governments of the Clinton and the Bush years had passed up many opportunities to regulate these credit default swaps. It was a little late to say we can't use government money reward risky behavior when government had taken a pass on preventing that behavior in the first place.

Liberals are tempted to take some satisfaction at seeing conservative shibboleths fracture on the hard rocks of reality. But I don't think we can afford to be smug. The lesson Henry Paulson learned, and the one we are continuing to learn, is just how tightly woven we are in the same garment of destiny. In general, free markets may make the best allocation of resources, but there has to be some restraint placed on practices which can harm the whole system. We thought the great depression of the Thirties had put basic protections in place. We were wrong.

The theory of moral hazard was wrong, not in its calculation of the incentives for risk-takers to take bigger and bigger risks, but in viewing the individual actor, be it investor or mega firm, as an actor divorced from the rest of the system, rather than as a thoroughly enmeshed in a network of relationships and obligations.

Why am I preaching on this? Not to educate you on economics – there are others far more competent than I for that. I preach on moral hazard because I think it has application in our lives. And one aspect where it certainly has application is in raising children and in relating to adult children. We want our children to feel supported and secure, but we also want them to learn to be independent.

Let me tell you a story. I will call them Wayne and Wanda; they worked for years in a big city of the Northeast in order to put aside enough money to retire to Cape Cod. They bought a modest retirement home, where Wayne enjoys birding and sailing, and Wanda enjoys gardening. But they have trouble with their daughter Wendy. Wendy has a substantial learning disability, had trouble making friends and developed a bad drug habit in her teens. Wayne and Wanda spent a small fortune in getting her to rehab programs around the country. After four tries, she finally got a bachelor's degree, but in her senior year she got pregnant and decided to keep the baby and raise him as a single mom. She was able to get by on part-time work, but now has been laid off and is faced with the option of moving to the Cape into the small house with her parents and the five-year-old, or going on public assistance in Philadelphia. Wanda and Wayne suspect she may still be using cocaine. Do they offer for her to come stay with them? Do they take money out of their meager savings to support her and her baby in a distant city? Or do they let her fail?

This story is fiction, but elements of it are in some of our lives, and the issues it raises are in many. I had an e-mail exchange with my ex-wife yesterday about the need for support of our unemployed lawyer daughter. Some of you have adult children living with you, others are considering taking them in. We're in hard times economically, and family ties are being called on. Robert Frost said "home is where when you have to go there; they have to take you in[4]."

Does moral hazard even apply here? You could say that families are families and ideas out in the world of public policy don't really apply in the family. We have obligations to family members that we don't have to the world at large. My need to have my children safe and secure is of a different order than the country's need to have its investment banks safe and secure.

And yet there is some connection. The parable of the Prodigal son[5] is to me an instructive story on moral hazard. The younger son takes his inheritance, and goes to a distant place and squanders it. Humiliated and starving, he decides to return home. He abases himself before his father, offering to work as a laborer, and his father rejoices and orders the household to kill the fatted calf and to feast. The older brother is disgusted at the partying, and he says to his father, in words dripping with the theory of moral hazard: I've served you faithfully for so long, and you've never given me even a young goat.

Parents can well understand the father's response: you have been with me always, but your brother was lost and now is found. Let us celebrate.

Let us celebrate. The family connection is more important than the question of moral fault or worthiness, more important than past risky behavior or incentives not to engage in future ones. As Henry Paulson came to understand that the survival of the financial system is more important than seeing firms get punished for risky investment strategies, so parents realize that the umbilical ties to our offspring are more significant than whether they have behaved in ways we might not approve. Classic Universalism reads the prodigal son parable as the unconditional love of God, which doesn't care what the errant child has done. At the end of the Sermon on the Mount, Jesus says:

> 9 Is there anyone among you who, if your child asks for bread, will give a stone? 10 Or if the child asks for a fish, will give a snake? 11 If you then, who are evil, know how to give good gifts to your children, how much more will your Father in heaven give good things to those who ask him[6]!

Now I recognize that, as against this prodigal son ethic, there is an alternative ethic called tough love, which is sometimes advocated for families of those struggling with addictions and which is basically moral hazard: tough love says the more you bail out your child from the consequences of their bad decisions, the longer they will keep making those bad choices. Tough love advocates setting limits, drawing lines and sticking to them.

The last time I was able to practice tough love with my children was when they were infants, and I thought I was being so firm by letting them cry themselves to sleep once I had put them down and checked on them once. I can remember my daughter at the crawling stage; I had put her to bed, she cried and cried and then I heard a bang, and when I opened the door I found that she had climbed

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[4]"Death of the Hired Man"

[5]Luke 16: 11-32.

[6]Matthew 7

out of her crib, fallen to the floor and crawled across to the door in protest. I think I rocked her to sleep in my arms that night. I wasn't much good at the tough love thing. I generally opted for trying to be the father in the prodigal son story.

We are all at risk, and we all engage in risky behavior. A bailout of Lehman Brothers would have rewarded risky behavior, but it might have averted some of the dire consequences that have now been visited on the rest of the system, by which we will all be affected in the years to come. Ideas, my friends, have consequences, even wrong ideas. *Especially* wrong ideas. The lesson I hope we are learning as a nation in these hard times is that we are all in the same boat, and punishing those whose risky behavior got us here has to yield to the imperative to keep us all afloat.

Amen.

Reading: Parable of the prodigal son, Luke 16

11 Then Jesus said, "There was a man who had two sons. 12 The younger of them said to his father,
'Father, give me the share of the property that will belong to me.' So he divided his property between
them. 13 A few days later the younger son gathered all he had and traveled to a distant country, and
there he squandered his property in dissolute living. 14 When he had spent everything, a severe famine
took place throughout that country, and he began to be in need. 15 So he went and hired himself out to
one of the citizens of that country, who sent him to his fields to feed the pigs. 16 He would gladly have
filled himself with the pods that the pigs were eating; and no one gave him anything. 17 But when he
came to himself he said, 'How many of my father's hired hands have bread enough and to spare, but
here I am dying of hunger! 18 I will get up and go to my father, and I will say to him, "Father, I have
sinned against heaven and before you; 19 I am no longer worthy to be called your son; treat me like
one of your hired hands."' 20 So he set off and went to his father. But while he was still far off, his
father saw him and was filled with compassion; he ran and put his arms around him and kissed him. 21
Then the son said to him, 'Father, I have sinned against heaven and before you; I am no longer worthy
to be called your son.' 22 But the father said to his slaves, 'quickly, bring out a robe — the best one —
and put it on him; put a ring on his finger and sandals on his feet. 23 And get the fatted calf and kill it,
and let us eat and celebrate; 24 for this son of mine was dead and is alive again; he was lost and is
found!' And they began to celebrate.

25 "Now his elder son was in the field; and when he came and approached the house, he heard music
and dancing. 26 He called one of the slaves and asked what was going on. 27 He replied, 'Your brother
has come, and your father has killed the fatted calf, because he has got him back safe and sound.' 28
Then he became angry and refused to go in. His father came out and began to plead with him. 29 But
he answered his father, 'Listen! For all these years I have been working like a slave for you, and I have
never disobeyed your command; yet you have never given me even a young goat so that I might
celebrate with my friends. 30 But when this son of yours came back, who has devoured your property
with prostitutes; you killed the fatted calf for him!' 31 Then the father said to him, 'Son, you are
always with me, and all that is mine is yours. 32 But we had to celebrate and rejoice, because this
brother of yours was dead and has come to life; he was lost and has been found.'"