Biennial Convention 2009

Go for Gold

19–22 April 2009 • Sydney

Institute of Actuaries of Australia

Walking Through The Moral Hazard Minefields

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Synopsis

- Moral hazard risk exists in many fields in which actuaries practice. Paper draws parallels between traditional fields and credit finance industry.
- Global Financial Crisis - Caused by:
  - Moral Hazard Risk
  - Regulatory Arbitrage (Uberrima Fide Vs Caveat Emptor).
- Solutions - Regulate to:
  - Remove regulatory arbitrage
  - Provide better and more succinct disclosure
  - Utilise principle of alignment of interests to produce "participating" securitised credit products so as to restore trust.

What is Moral Hazard?

- It is the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk.
- It is often related to information asymmetry (i.e. undisclosed essential information).
- Can be thought of as a party not entering into a transaction in good faith.

Legal Concepts

- Uberrima Fide (utmost good faith) underpins transfer of risks through insurance mechanisms.
- Caveat Emptor (let the buyer beware) underpins transfer of risks outside of insurance mechanisms.
- Leads to regulatory arbitrage. Should this remain?

Life Insurers

- Miss-selling was often caused by front end commissions not being disclosed. Moral hazard mines created but usually only exploded if there are early surrenders.
- Competition made management of this risk difficult. Needed regulatory involvement to ensure worst insurer wasn't rewarded by obtaining the best agents.
- Questions
  - Should there be disclosure requirements of inducements (commissions) payable to sellers of securitised credit products.
  - Does the distribution channels used change the moral hazard risk embedded in securitised credit products?

Buyers of Life Insurance

- Non disclosure of risk.
  - Innovative information sharing can be used.
- Collusion between agent and insured can occur.
  - Financial interests of agent and insured aligned against insurer.
- Alignment of Interest principle is important
- Questions
  - Could there have been collusion between the credit originators and the credit purchasers to the detriment of the investors of the subsequent credit products?
  - What effect would an appropriate disclosure regime have had?

Life Reinsurers

- Alignment of interest principle important in life reinsurance.
  - Known as "retention policies".
- Questions
  - Should the alignment of interest principle apply in credit securitisation?
  - How important is the essential difference between life insurance reinsurance and securitisation given that the reinsurance process aggregates risks whereas the securitisation process tends to disaggregate risk?

Buyers of General Insurance

- Often no disclosure of financial interest of intermediary.
  - Insurer gets away with this because contracts seldom terminated resulting in repayment of premium.
- Question
  - Are the purchasers of credit products advised of the commission payable to the intermediary? What about other "commissions" paid during the securitisation process?

General Insurers

- No or poor disclosure can occur at purchase and at claim.
  - At times claims are fraudulent (claim and/or extent of claim).
  - Wholesale fraud has occurred in Workers Compensation.
- Difficulty of providing insurance against something known in advance.
- Questions
  - How easy was it to perpetrate wholesale fraud on the ultimate underwriters of credit given they were principally unsophisticated investors?
  - To what extent did deliberate untruths play a part?

General Reinsurance

- Aggregation of risks is an important issue for reinsurers.
- Reinsurers demand knowledge about risks before taking on part of them.
- Counter party risk makes evaluation of reinsurer by ceding insurer important.
- Questions
  - Would an insurer legally pass on products with embedded US Sub-Prime risks to a reinsurer without disclosing them?
  - Why did regulatory regimes fail to understand the information asymmetry between the investors and the issuers of this risk?
  - Was the counterparty risk of many credit default swaps ignored?

Buyers of Health Insurance

- Disclosure is complex because of information overload.
  - Development of mandatory Key Features Statement.
- Insurable interest issues if the buyer not the insured.
- Sovereign risk and market power are important.
- Questions
  - Did sovereign risk play a part in the incorporation of moral hazard risks within credit products?
  - Could future sovereign moral hazard risks be averted by appropriate regulatory regimes?
  - Would the concept of a Key Features Statement be useful in disclosing information to borrowers and investors?

Health Insurers

- Insurance modifies insured behaviour.
- Regulation can modify insurer behaviour.
  - Portability makes competition between insurers reduce benefits for chronic illnesses.
  - Low pre-existing waiting periods resulted in need for other (expensive) insurance incentives.
- Unhealthy people don't usually withdraw from health insurance.
- Questions
  - Was the interaction of credit financiers in the US and their Government similar to the interaction of Australian health insurers and their government?
  - Did competition issues create additional moral hazard risk for credit issuers?
  - Do credit risks deteriorate with time in the same way as health insurance risk and if so how can this be mitigated?

Health Reinsurance

- Claims equalisation system.
  - Minimum retention by smallest insurer is 18%.
  - Minimum retention increases with size of insurer.
- Question
  - Should there be a minimum risk retention requirement for credit originators who reinsure (securitize) the credit they provide?

Superannuation

- Miss-selling investment strategies to increase commissions.
- Using position of power to obtain advantage.
- Use of subordination of function to more experienced.
- Questions
  - Was there miss-selling of credit?
  - Did the merchant banks and the rating agencies use their power for their own gain at the expense of clients?
  - Is subordination of a function to the less experienced an ethical business practice? What if, in the process, the subordinator deliberately hides the risks included within the subordination?

Credit - Borrowers

- Professional Specialisation leads to complex credit documents. Simple disclosure (Key Features) statements are needed.
- If loan is intentionally not going to be held on the balance sheet should the borrower be told?
- Should the borrower be told of any up-front “profit” or commission to be made by the seller? Should profits made by any intermediaries between the seller and the eventual holders of the credit risk be disclosed?
- If the loan financing intentions of the credit provider change after sale of the credit should the borrower be given updated information?
- Are Australian low-doc loans and US Sub-prime similar?
- How much miss-selling of credit occurs in Australia?

Credit - Suppliers

- To what extent will a credit supplier's considerations change if the intended credit was to remain wholly on the books of the supplier or wholly securitised?
  - The ability of the applicant to pay the interest (including after any honeymoon rate)?
  - The ability of the applicant to repay the capital (either during the term of the loan or at the end of the term of the loan)?
  - If capital is to be repaid at end of term of loan is this intended to be by raising a new loan? If so what consideration is given to the risks of a new loan not being available?

Credit - Reinsurance (Securitisation)

- It seems that profits were syphoned off at many stages of the credit securitisation process. To what extent did this occur because of deliberate attempts to conceal the truth from the credit purchaser, the credit originator and the ultimate holders of the credit risk (including any holder of an attached credit default swap)?
- How should the regulatory arbitrage between transfer of risks in insurance environment and outside insurance environment be addressed?
- Had there been a mandatory credit retention requirement would the excesses that did occur still have occurred? What if the retention requirement had originated from sensible business practice – say via the rating of the product by a rating agency?

Management

- Management By Objectives can create moral hazard risks. So too can Key Performance Indicators.
  - The US consulting actuarial practice leader that required each subordinate actuary bill 6 hours more a week.
  - The consultant that regularly billed more than 200 hours a week.
  - The managements that fudge figures to get their KPI bonuses.
  - The rating agencies that get paid for providing a rating – but are immune from legal process arising from incorrect ratings.
- Questions
  - What role did profit motives play in the GFC?
  - Should rating agencies come under some form of international law? What protections are required?

Conclusions – Moral Hazard

- Moral hazard risk occurs when there is information asymmetry.
  – Insurance - legal requirement of “utmost good faith”.
  – “Buyer beware” for risks transferred outside insurance environment.
- The principle antidotes to moral hazard risk are:
  – Disclosure.
  – The alignment of interests of contractual parties.
  – Usually a combination of regulation and management is required for antidotes to work effectively.

Conclusions – Credit Products

- Key Features Statements are a useful tool for disclosure of credit information.
  - Should be a one page strictly formatted document.
  - Kept on a Government website.
- “Participating” securitised credit products will:
  - Restore trust to credit markets.
  - Enable existing products to be “rolled over”.
  - Expand credit availability sensibly.
- Governments should address regulatory arbitrage.
  - Disclosure requirements of risks transferred within insurance environments and outside insurance environments.

The End