

# **Moral Hazard**

## **Recent Evidence Corroborates Old Theory**

The 1<sup>st</sup> Inter-Regional Conference of IADI:  
The Role of The Deposit Insurance Systems in Enhancing Financial Stability in  
Different Countries

Presentation by Mohammed Al-Ja'fari / General Director, DIC of Jordan  
1<sup>st</sup> IADI Inter-Regional Conference Istanbul-Turkey, June 26-27, 2007

## **Moral Hazard: Recent Evidence Corroborates Old Theory**

- Moral Hazard: General Economic Phenomenon
- Moral Hazard and Banking
- Deposit Insurance and Moral Hazard
- Empirical Research
- Early Warning Signs
- Tools to Contain Moral Hazard in Financial System when Insuring Deposits
- The Jordanian Experience
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## **Moral Hazard: General Economic Phenomenon**

- **Moral Hazard:** Incentive for Riskier Activities  
Moral Hazard affects negatively the incentive structure of the financial system which may lead to systemic crisis.
- **Asymmetric Information Problem:**  
One party's insufficient knowledge (depositors) about the other parties (banks) involved in a transaction makes it possible to make inaccurate business decisions.
- **Adverse Selection:** wrong investments, wrong business partners or wrong borrowers.

## **Moral Hazard: General Economic Phenomenon**

### **Moral Hazard and Deposit Insurance:**

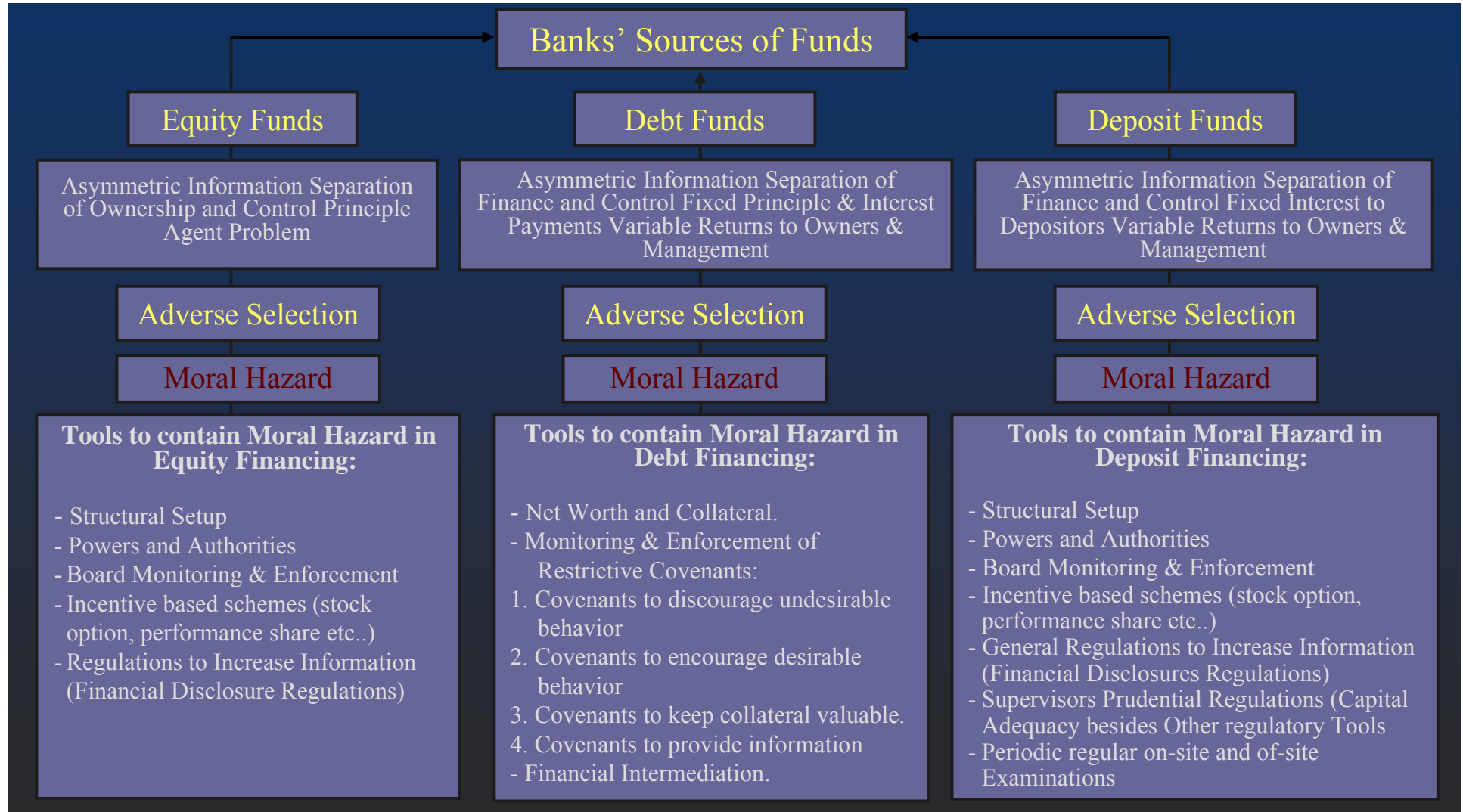
- Insured depositors seek less information (Asymmetric Information Problem)
- Banks select wrong business partners and riskier investments.
- Banks run the risk that the borrower will engage in activities that are undesirable from the depositors' point of view (because they make it less likely that the loan will be paid back).



### **But, Moral Hazard is a General Economic Phenomenon:**

- It is there in commodity and financial instruments transactions (The Lemons problem), in equity finance in general (The Principal – Agent Problem), Debt finance and all insurance settings.
- All banks' financing sources are subject to Moral Hazard.

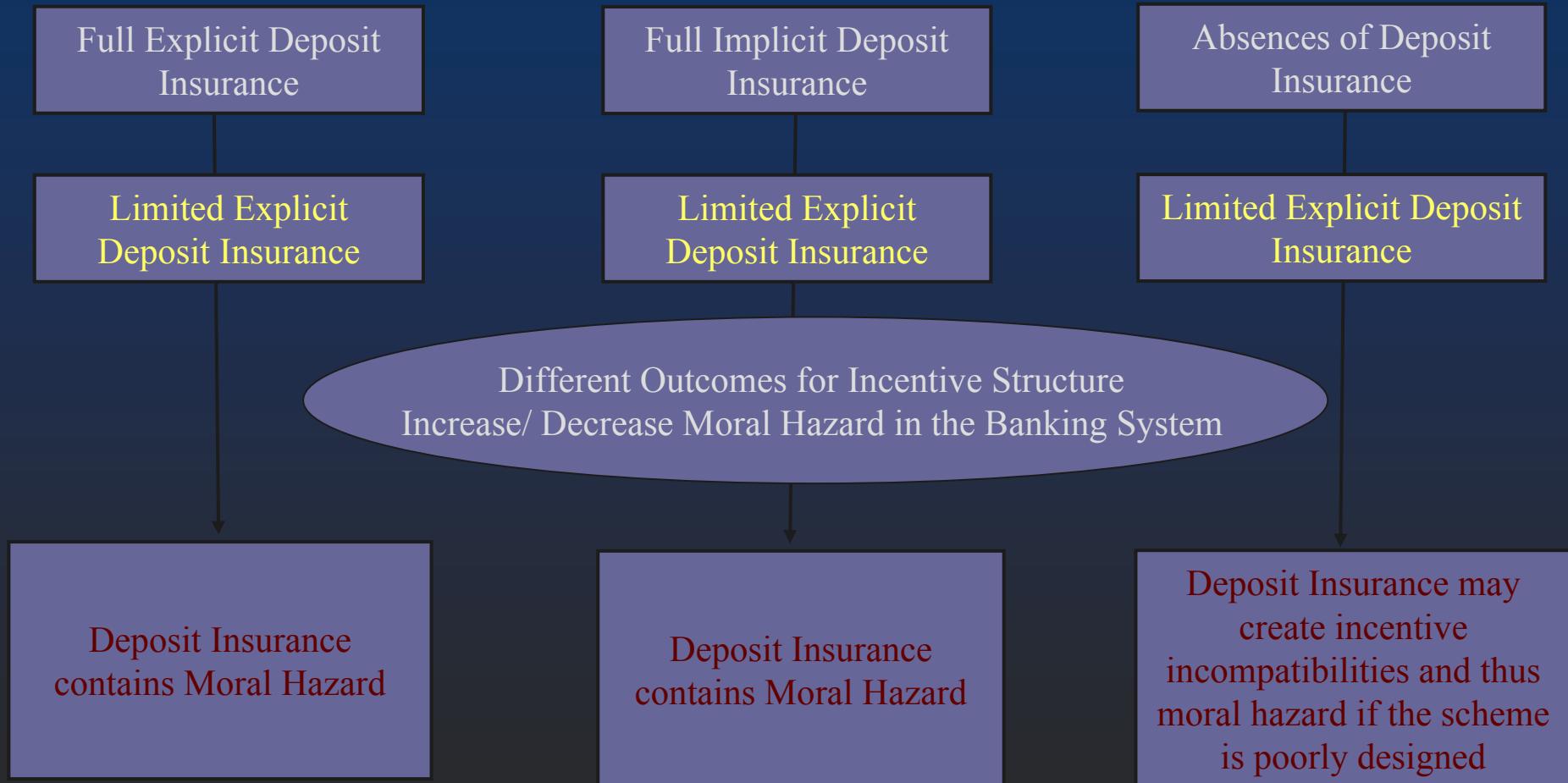
# Moral Hazard and Banking



## Deposit Insurance and Moral Hazard

- Protected depositors have less incentive to monitor banks.
- Banks have more incentive to take excessive risks when depositors are protected.
- Deposit Insurance may increase Moral Hazard.
- Recent Experience reveals significant increase in the number of countries adopting deposit insurance schemes.
- Deposit protection prevents bank-panics, provides confidence and promotes financial stability.
- There is a need then to design and adopt an effective deposit insurance scheme that promotes financial stability but contains Moral Hazard.
- Different countries have different protection schemes before the adoption of an explicit limited deposit insurance system; so that the newly adopted systems must have different implication on Moral Hazard.

# Moral Hazard in Deposit Insurance



## Full Coverage to Prevent Banks Failure





# Empirical Research on The Relationship between Deposit Insurance & Moral Hazard

Limited/Full ...Explicit/ Implicit Deposit Insurance

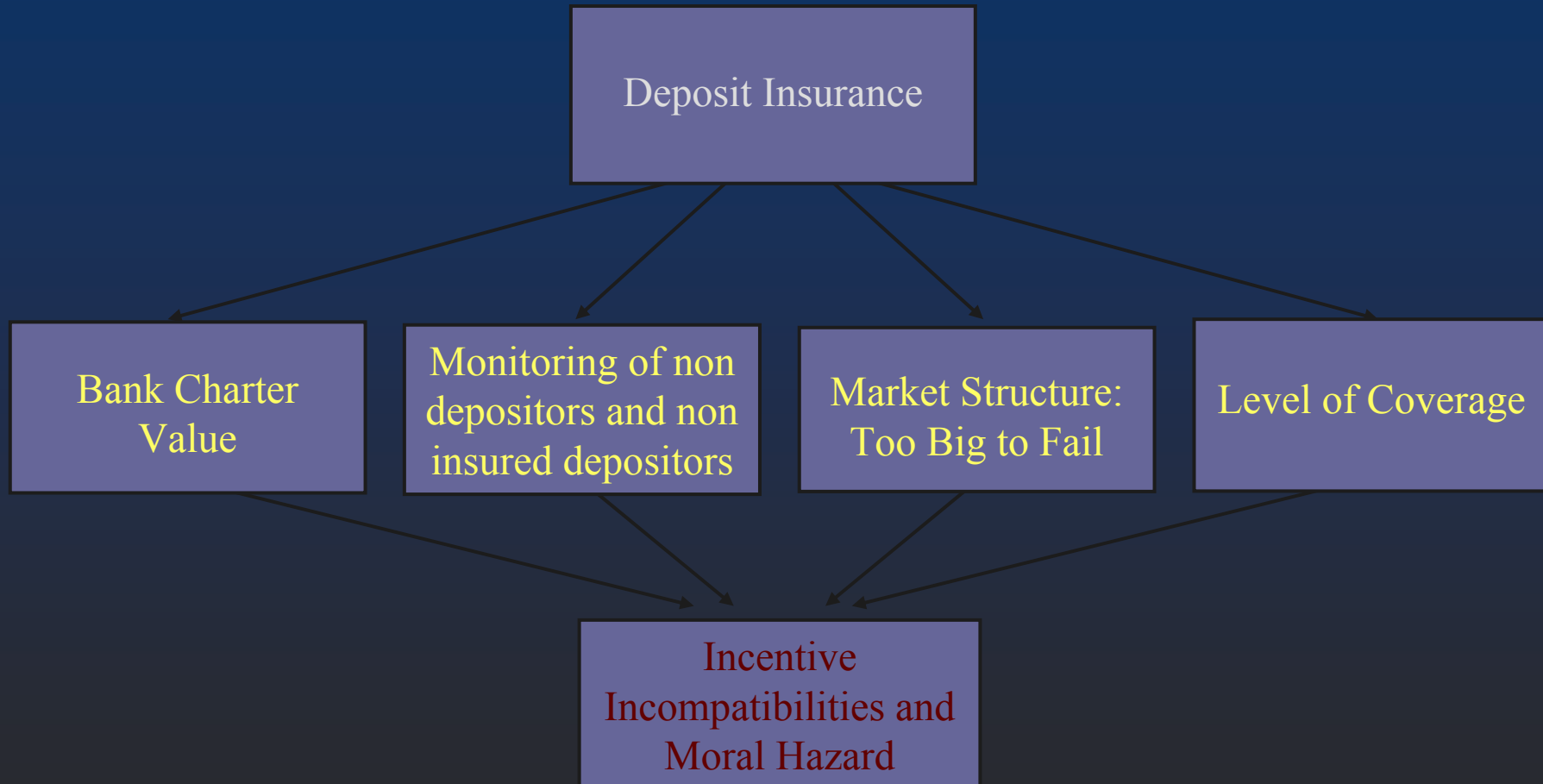
Weaken/ Strengthen

Market Monitoring

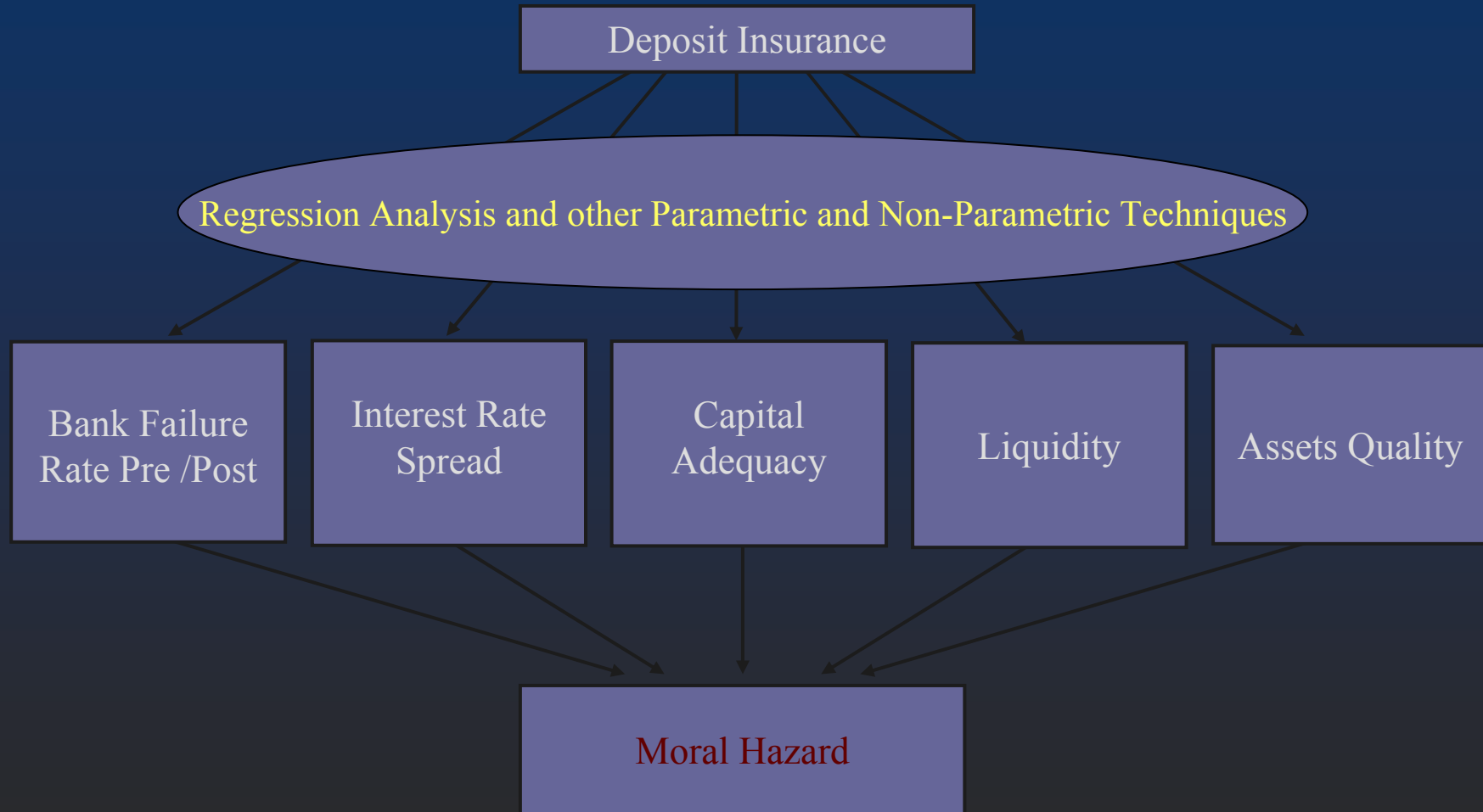
Increases/ Decrease

**Banks Risk Taking: More Moral Hazard**

# Empirical Research on The Relationship between Deposit Insurance & Moral Hazard



# Methodology, Surrogates and Research Design



## Main Findings of the Empirical Research

- Unlimited explicit deposit insurance increases Moral Hazard; it distorts the incentive structure in the banking system and prevents the proper functioning of the market discipline mechanism and leads to excessive risk taking.
- The introduction of limited explicit deposit insurance may reduce banks' risk taking and Moral Hazard.

## Early Warning Signs

- Deposit Distribution and market shares
- Competition in the banking sector and interest rate levels
- Alarming growth rates in balance sheet and off-balance sheet activities
- Assets quality
- Capital adequacy ratios
- Management Efficiency
- Activities of banks on the watch list and critically under capitalized banks

## Tools to Contain Moral Hazard in Financial System when Insuring Deposits

Several Safeguards can be applied to contain moral hazard when introducing/ revising deposit insurance scheme:

- Strong prudential banking regulations in place
- Properly designed deposit insurance scheme (Scope and limit at coverage; types of insured deposits, membership policy, powers and authorities, interrelationship architecture...)
- Public Awareness
- Coinsurance or full coverage for small deposits while applying haircuts on large deposits
- Incentives to uncovered large depositors, creditors and shareholders to monitor their banks
- Tough resolution techniques; prompt closure for critically under capitalized banks
- Risk Reducing features: risk based premium (evidence suggest that risk based premiums work better than flat premiums)
- Examination and yardsticks need to be timely and objective

## The Jordanian Experience

- Explicit limited coverage introduced after decades of explicit unlimited coverage; adopted in normal stable economic and financial conditions.
- Only Jordan Dinar deposits are insured up to JD10,000 (USD14,100):
  - Three times average deposit
  - Five times per capita GDP
  - 94% of depositors
  - 15% of the total deposits
- Compulsory membership, all member banks subject to Central Bank regulations and off-site and on-site examinations.
- Memorandum of understanding between the Central Bank and the Deposit Insurance Corporation covers cooperation, action- coordination and information-sharing.

## Concluding Remarks and Policy Recommendations

- Moral Hazard is a general economic phenomenon.
- Banks' investment and financing contractual relations are subject Moral Hazard in general.
- The move from blanket coverage (explicit or implicit) to well-designed explicit limited deposit insurance scheme curbs moral hazard.
- The adoption of explicit limited deposit insurance scheme may increase banks risk taking and moral hazard if the system is poorly designed.
- There are several signs and signals for increased moral hazard in the system that need to be monitored, when these signs are attributed to the deposit insurance scheme, the scheme need to be redesigned to curb moral hazard to prevent excessive risk taking.



## Concluding Remarks and Policy Recommendations

To contain moral hazard when designing/revising an explicit limited deposit insurance scheme:

- Adequate market discipline for efficient monitoring of banks activities for all stakeholders (uncovered large depositors, creditors and shareholders)
- Strong institutional setup and close cooperation among safety net participants
- Strict banking regulations in place
- Effective clearly communicated DI scheme that limits the scope and coverage amount
- Tough resolution policies

*Thank you for your kind attention*

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