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MORAL HAZARDS AND PRINCIPAL-AGENT PROBLEM

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Unlike the perfectly competitive market model, the financial markets in actual practice are typically characterised by numerous information asymmetries that in turn lead to adverse selection at the ex-ante stage and moral hazards at the ex-post stage. In credit markets, for instance, after being given a loan even a good credit risk may indulge in a behaviour which is detrimental to loan repayment and hence unethical or immoral from the viewpoint of the lender. Such moral hazards could be in the form of commissions as well as omissions. Likewise, in equity markets, moral hazards take the form of Principal-Agent problem. More specifically, as owners or Principals are numerous in equity contracts, they appoint a selected few managers or Agents to look after the organisation who in turn may indulge in various commissions and omissions that can be considered as immoral from the viewpoint of owners and organisations concerned. Such a moral hazard or Principal-Agent problem could manifest itself in the form of commissions like extravagance, financial frauds and insider trading or omissions like not putting enough effort for the growth of organisation. Even Mergers & Acquisitions could be a manifestation of the Principal-Agent Problem in case they are dictated by the greed for power on the part of agents or managers rather than the interests and growth of the organisation concerned. As the costs of State Verification are quite high, it is generally not feasible to detect and penalise such errant behaviours in an organisation. But by following a proper system of incentives for the deserving and disincentives for the undeserving managers, an organisation can effectively overcome the Principal-Agent problem. For instance, the managers or agents exhibiting outstanding performance could be given monetary rewards, appreciation certificates or could be felicitated publicly and be given equity shares of their organisation as a reward so as to develop a sense of belonging and loyalty to their respective organisations thereby overcoming the Principal-Agent problem.

As opposed to the perfectly competitive market model, the financial markets in actual practice are invariably characterised by incomplete and asymmetric information. Whenever there are information asymmetries in any financial or credit market, some participants tend to have better access to the relevant information *vis-à-vis* other market participants. This is what in turn leads to the problems of *adverse selection* and *moral hazards*. Adverse selection typically occurs at the *ex-ante* stage whereas moral hazards by their very nature arise at the *ex-post* stage.

For instance, if a lender gives loans to *bad credit risks i.e.* undeserving and dishonest borrowers, then it represents “adverse selection”. If, however, even *good credit risks* after getting the loan start indulging in a behaviour which is detrimental to loan repayment and hence is immoral or unethical from the perspective of the lender then it is a clear-cut manifestation of “moral hazards”.

Let us, for example, take the case of a borrower who took a loan for starting a local family restaurant. Given that he was an honest borrower with all the intention to repay the loan and his project was found to be commercially viable with tremendous demand in the market and ability to effectively meet that demand through the availability of competent chefs to produce delicious delicacies & cuisines, there is no adverse selection in advancing a loan to him. But at the ex-post stage *i.e.* after the sanctioning of loan, it could quite conceivably happen that the borrower indulges in many *commissions* & *omissions* that are antithetical to loan repayment. Once this happens, it is a clear-cut case of moral hazards. For instance, the borrower may outrightly indulge in a breach of trust by diverting the funds from the setting up of local family restaurant to blowing up the money in activities like gambling. Likewise, the borrower may embezzle the funds or siphon them off to some other activity due to which he is eventually unable to repay the loan along with associated interest rate earlier agreed upon by him. Such a fraudulent behaviour falls in the category of “commission” and is out and out a moral hazard.

Similarly, the borrower may indulge in “omissions” by not paying enough attention to the venture *i.e.* local family restaurant for which he had taken the loan. For instance, most of the times he may be absent from the restaurant even at peak hours as he started giving precedence to his leisure, entertainment, personal comfort and the like over and above the customers’ needs and growth of the family restaurant at hand. Out of sheer lethargy, demotivation or callous attitude, he may not take proper care of decoration, cleanliness, hygiene, food quality and the general environment in the restaurant or may behave rudely with the customers thereby losing on his business. All these are various manifestations of moral hazards in credit markets.

It is worth noting that such moral hazards arising out of information asymmetries are not confined to credit or loan markets alone. Even in equity markets, due to the underlying asymmetry of information, moral hazards do arise in the form of “Principal-Agent Problem”. More specifically, in recent years owing to the increasing technological advancements and associated diversification of consumption basket, the need for funds for financing any meaningful productive activity has become very huge and colossal due to the standard economies of scale argument. This in turn has led to the emergence of equity contracts and development of equity markets whereby the ownership of an organisation is spread across a large number of owners or “Principals” depending upon the extent of their individual equity holding. Since such a large number of owners or Principals cannot be reasonably expected to manage modern-day organisations, they appoint a selected few managers as their “Agents”. This *managerial revolution* or effective separation of ownership from control in equity markets, in turn, leads to a moral hazard in the form of “Principal-Agent Problem”.

What this essentially means is that when numerous owners or “principals” rely on a selected few managers or “agents” such as sales manager, advertising manager, marketing manager, personnel manager and the like to look after their organisations, the agents may indulge in various commissions and omissions that are unethical or immoral from the viewpoint of principals and organisations concerned thereby leading to the principal-agent problem. For instance, the agents or managers may indulge in extravagance, financial frauds & embezzlements, insider-trading and manipulations of various kind. Likewise, the agents may not put enough effort for the growth of the organisation due to lethargy, demotivation, lack of loyalty or a sense of belonging to their organisation. In fact, even “Mergers & Acquisitions” could be a manifestation of the Principal-Agent problem in case they are dictated by the greed for power on the part of agents or managers rather than the genuine interests or growth of the organisation.

As far as overcoming the Principal-Agent problem is concerned, one possible solution is to put surveillance over the activities of agents and penalise them in case of any immoral practice undertaken by them. But this is more easily said than done because the costs of “State Verification” are quite high. That is to say, it is quite costly to detect any errant behaviour on the part of managers or agents before they could be penalised for the same!

As a viable alternative, however, a proper system of incentives and disincentives could be devised by an organisation whereby there are rewards and incentives for the deserving agents and disincentives for undeserving managers or agents. The incentives for deserving managers may not be only in the form of monetary rewards but could also be in the form of giving appreciation certificates, publicly felicitating them for their outstanding performance and the like. Those who under-perform as managers are automatically deprived of these benefits and accolades and thus face a disincentive in terms of standard “opportunity cost” argument. In order to develop among managers or agents a sense of belonging to the organisation, it is often suggested that they could also be rewarded in terms of some equity shares of their organisations concerned so that they start identifying with their organisations and develop a feeling of loyalty towards the same. All these measures can be reasonably expected to overcome the moral hazard problem arising in the form of “Principal-Agent Problem” in equity markets.