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# Theoretical Framework for Research on the Factors Affecting the Moral Hazard in Banking Operation

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## Abstract

There are many types of risks related to banking operations such as credit risk, interest risk, operational risk. Problems related to moral hazard have led to considerable setbacks for the economy in general and banking system in particular. Besides, moral hazard is an economic and financial terminology and is used to denote the risk generated from the deterioration in ethical conduct. Hence, authors aim at reviewing theoretical framework for determinants impacting moral hazard in banks.

**Keywords:** Moral Hazard, Banking Operation, Theory of Planned Behaviour, Agency Theory, Attribution Theory, Theory of Reasoned Action

## 1. Introduction

In Vietnam as well as around the globe, many issues related to moral hazard have led to considerable setbacks for the economy. There are many types of risks related to banking operations such as credit risk, interest risk, operational risk. Besides, moral hazard is an economic and financial terminology and is used to denote the risk generated from the deterioration in ethical conduct. In 1995, Nick Leeson, 28 years old, a staff member in Singapore generated a loss of 1.4 billion USD because of his speculative investment in futures contracts. In September 2016, Wells Fargo bank in the US discovered more than 1.5 million unauthentic bank accounts created by its staff members in the period between 2011 and 2015 to illegitimately earn millions of USD of fees from customers. In Vietnam, in recent years, the authorities have unveiled wrongdoings of bankers, leading to losses that amount to billions of VND, such as lending without collaterals that are registered for secured transactions, lending customers who do not meet standards of borrowing, lenient supervision of covenants for loaning, inappropriate categorization of debt, lending customers with unjustified use of loan, lack of provisioning or illegitimate provisioning, lending customers with credit rationing.... It is very difficult to discern moral hazards in banking operations. However, moral hazard may entail serious consequences such as: reducing the effectiveness

of banking operations, generating considerable losses in assets, which may result in bankruptcy, customers suffering from considerable financial losses resulting from the downfall of a bank... Therefore, many factors affect moral hazard in banking operations such as: banking staff members receive bribery from customers when completing transactions and issue refinancing; providing loans for risky projects; some even attempt to hinder customers in order to receive compensation. On the other hand, on the customer's side, moral hazard is reflected in the fraudulent behaviours such as creating unauthentic profiles. Therefore, to minimize moral hazard in banking operations, important theoretical frameworks should be built as a premise for appropriate policies and risk management models.

## **2. The theoretical framework for research on factors affecting moral hazard in banking operations**

### *The theory of reasoned action*

The foundation of the theory of reasoned action was first developed in 1967 by Fishbein and was further amended and developed by Ajzen and Fishbein (1975). According to the theory, a hypothetical behaviour can be predicted or explained by the propensity to perform the behaviour (Ajzen I, 1975). The hypothesized propensities include the factors and incentives that affect the behaviour and these are defined as the level of effort that human beings exert to perform the behaviour (Ajzen I, 1991). According to this theory, individuals have an incentive in the process of decision-making and choosing the best decision among the possible options to carry out the behaviour. Ajzen & Fishbein (1975) stated that behaviour is subject to the attitude towards the behaviour and the subjective standards of the behaviour (Ajzen I, 1975). This theory can be applied to the analysis of moral hazard in banking operations, and indicates that the behaviours that result in moral hazard are greatly influenced by demand and motivation of humans. An unjustified behaviour stems from the demand of the individual performing that behaviour. The demand results in the incentive to perform the behaviour. In other words, this behaviour is intentional, and the vehicle and objective of the action are compatible with each other. However, the behaviour that causes the risk should be viewed on both a subjective and an objective basis. Because, in reality, a behaviour is not only subject to attitude and awareness but also external factors. The positive aspect of behaviour is that it urges the subject to work toward the goals. For example, a bank teller forges customers' profiles and seals in order to appropriate customers' assets. The tools, vehicle and objective of this behaviour are all compatible with each other. The consequence of this behaviour can be predicted. However, in some cases, this behaviour might not be performed since the subject is confined by many factors such as environment, conditions for performance, banking administration system or legislation. Therefore, this theory is used to explain intentions of wrongdoings such as criminal actions, violation of ethical standards or moral hazard. However, a shortcoming of this theory is that it proposes that behaviour is controlled by determination. Therefore, this theory can only be applied to rational and purposeful behaviour that is planned by a subject. On the other hand, it is clear that behaviour is also subject to external factors, which means that a subject may not perform the behaviour. For example, a bank may have a rigorous administrative system, which reduces moral hazard. On the contrary, a lack of control or improper control system might be an opportunity for subjects to perform wrongdoings. In addition, if a subject performs the behaviour out of habit, then the behaviour is not rendered intentional. Therefore, this theory cannot explain these behaviours.

### *The theory of planned behaviour (Ajzen, 1991)*

The theory of planned behaviour is developed on the basis of the theory of reasoned action. According to Ajzen, the advent of the theory of planned behaviour originates from the limitation on the behaviours that human beings have little control of, albeit the fact that they are highly motivated by attitude and subjective norm. However, in some cases, they do not perform the behaviour because of the external effect on their intention. Ajzen further complemented the theory by adding the factor of perceived behavioural control. Perceived behavioural control reflects the ease with which the behaviour can be performed and whether there is any limitation on the behaviour (Ajzen. I, 1991).

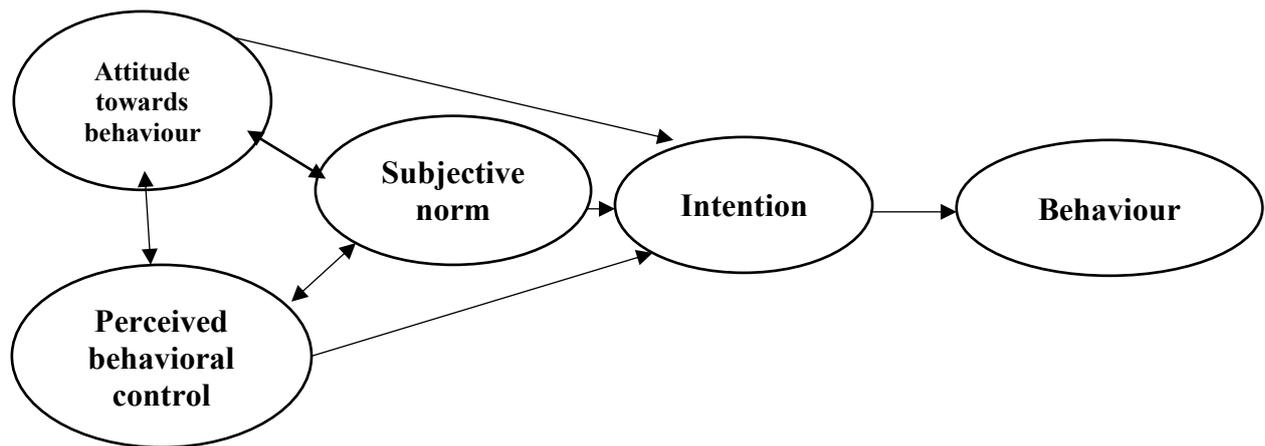


Figure 1: The model of the theory of planned behaviour (TPB) (Ajzen, 1991)

According to the model, motivation and intention are the fundamental factors leading to consumer's behaviour. Therefore, motivation is affected by 3 fundamental premises: (i) the personal factor or the attitude towards intention, which is the positive or negative attitude towards performing the behaviour; (ii) subjective norm and (iii) the decisive factor of self-perception and ability to perform the behaviour, which is called perceived behavioural control (Ajzen, I, 1991).

From the aforementioned theories, it can be seen that moral hazard has a close relationship with the factors in the model. The attitude of the subject can be positive or negative. The positive attitude indicates the concurrence and approval of positive viewpoints such as honesty in banking transactions. On the other hand, the negative attitude is indicative of the greed and dissatisfaction that might lead to negative behaviours in banking operations.

The subjective norm can be described as the awareness of an individual of the society's pressure on whether to perform a behaviour or not. Preceding studies also proposes that subjective norm and intention are directly proportional. Therefore, the subjective norm can be measured via people who affect the subject of moral hazard such as friends, colleagues. This reflects the fact that moral hazard in banking operations can result from the encouragement and approval of individuals and groups whose behaviours are deviated from the normal standard. In fact, the types of moral hazard in banking operations are interrelated. Therefore, moral hazard is more likely to happen in the presence of advocacy from a group of people, which motivates the unethical behaviour of the subject.

Perceived behavioural control is defined as the personal feeling of whether performing the behaviour is easy or difficult. This reflects the level of control on behaviour performance but not the result of the behaviour. In this sense, moral hazard in banking operations can originate from individual behaviour, awareness and the control that a subject exerts on his or her behaviour greatly affects the decisions. Additionally, the lenient controlling system of banks may be an opportunity for fraudulent actions, and vice versa.

The theory can be applied to research on factors affecting moral hazard in banking operations and can be used to predict and explain people's behaviour in causing moral hazard. Thus, the relationship between attitude and behaviour can be clarified. The subjective norms investigate the intra-group relationship leading to the subject's decision of whether to perform the behaviour or not. If the violation of ethics is accepted, then moral hazard becomes more likely. In addition, perceived behavioural control is important in controlling moral hazard in banks. This implies that managers of moral hazard must propose mechanisms to control moral hazard in banks.

However, the demerits of this theory are unveiled when it comes to the explanation of moral hazard in banks. Apart from factors such as attitude, subjective norm, perceived behavioural control, there are many other factors leading to moral hazard. In fact, the intention to perform a behaviour does not guarantee the actual performance of the behaviour. Human beings can alter their perception, awareness or behaviour because of many factors. Individual

attributes, intra-group conflicts can increase the probability of moral hazard, while the theory does not mention these factors.

### *Agency Theory*

Jensen (1976), in the publication "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" introduced his viewpoint of agency theory. Economists, financiers pay special attention and use many quotations from this publication, which indicates its importance as a theoretical framework in studying agency costs. The theory originates from a psychological basis. In theory, human beings are predisposed to individual benefits. Then how can individuals strike a balance between their own benefits and mutual benefits to facilitate mutual development? The conflict of benefits between the owner and the agency was first highlighted in the XVIII century by Adam Smith in his studies and was further developed by Jensen and Meckling (1976), Myers (1977), Ross (1973), Leland-Pyle (1977). The theory focuses on the following issues:

First, there is always an opposition of benefits between the capital's owner and the agency. The capital's owner concerns are the benefits of the firm and themselves, while the agency cares about their benefits pertaining to the position they are holding such as salaries and bonuses. Second, the inconsistency in the benefits of the owner and the agency increases the cost of firm administration and results in financial losses. Third, the agency cost becomes higher when the agency holds a small number of stocks of the firm or does not hold any stock.

Therefore, the theory believes that there are two types of moral hazards in the firm's operation. The first type happens when the owner, in pursuit of individual benefits, invests in risky projects, leading to the failure of the firm to repay debts. The second type happens when there is conflict of interest between stockholders and the agency. In addition, moral hazard is a consequence of the conflict of interest between customers and service providers when asymmetric information is in place (Keil, 2005). Jensen and Meckling (1976) proposed that the main reason leading to the moral hazard between the owner and the agency is asymmetric information. Asymmetric information is related to the fact that the owner cannot be assured by the behaviours and cannot control the behaviours of the agency. On the other hand, the agency is also affected by the asymmetric information if the owner conceals the necessary information (Jensen, 1976). The asymmetric information causes the parties involved to work in uncertainty, which is not desirable for any party (Mahshid, Shirin, Mahdieh, 2014).

The agency theory can be applied to studies of the factors affecting moral hazard in banking operations. Moral hazard may stem from the people in charge of the banking system and the administrators. The main business of banks is money, therefore, the circulation of money is considerable. As a result, the Board of Directors may be involved in risky investments to generate profit, which affects the long-term benefits of banks. In fact, individual benefits, or the benefits from the remuneration policies may cause administrators to become accomplices with other individuals or firms in forging profiles or debt certificates. This may lead to risks, financial losses or bad debts from firms, and thus, leading to considerable losses for the banking system. The banking industry undergoes rigorous control and has few investment opportunities, therefore, compensation in the form of stocks or rights to stock ownership is less common than other industries. This creates little motivation to accept risks for the Board. The banking business is accompanied with a high rate of bad debts. The asset size is large, therefore, it is hard to control credit investments and loans. If the benefits of the owner and the agency are closely tied, other creditors such as depositors may be at higher risks. On the other hand, the conflict of interest between the stockholders and the agencies causes possible financial costs. The firm's objective is also not taken into consideration, and the pursuit of individual benefits may lead to violation of ethics in banks. Besides, the information asymmetry between the customers and the service providers leads to a lack of necessary information: customers may not understand or not fully understand the bank's principles. This may lead to conflicts or even obtaining the customers' property by fraud from the banking staff members.

### *Attribution theory*

Attribution theory is proposed to account for the way we evaluate a person; the different ways in which we rely on the significance assigned to a particular behaviour. Basically, this theory proposes that upon observation of an

individual's behaviour, we attempt to identify whether the behaviour stems from subjective or objective factors. Subjective behaviours are the behaviours controlled by an individual. Objective behaviours are the result of an external factor, in other words, the performance of that behaviour is mandatory, considering the situation. Three factors must be identified in order to identify the reasons for a behaviour (McShane & Von Glinow, 2005):

**Distinctiveness:** Distinctiveness refers to whether an individual performs the same behaviour in different situations and whether the behaviour occurs on a regular basis. If an individual's behaviour is not the same in situations, the observer can ascribe the behaviour to external reasons. If the behaviour occurs more than once, it is possible that there are internal reasons. These arguments can be applied to the analysis of factors affecting moral hazard in banks and indicate that violation of ethics can be explained by human beings' behaviour in subjective and objective contexts. Violation of ethics may reflect the subjectiveness of the individual when the violating behaviour frequently occurs in different contexts. For instance, a banking staff member already performs violating behaviours in different contexts. Therefore, violation has become systematic and loses its distinctiveness. On the other hand, violating behaviours can occur in different contexts when the conditions are conducive to the performance of these behaviours. This can explain the distinctive behaviours.

**Persistence:** This refers to a person with the same behaviours at different timing. According to the theory: if a behaviour is the same in many situations, then the causes are external reasons. On the contrary, if a behaviour is not the same in many situations, then the reasons for the behaviour are internal reasons. This can explain the fact that moral hazard in banking operations may stem from internal and external reasons. If the violation of ethics occurs in many situations, then the reasons might stem from the bank's controlling system. As a matter of fact, if the bank has a lenient system of control, then violation of ethics may occur more frequently, and vice versa.

**The consistency of behaviour:** This considers whether others' behaviour is the same as the one we are evaluating. If others behave in the same way, then consistency of behaviour in this case is high, and vice versa. This can be applied to research on moral hazard and indicates that if the consistency of behaviour is high, then the reasons are internal reasons. This points out that personal virtues and education play an important part in controlling moral hazard. In other words, moral hazard in banks stems from individual behaviours, greedy behaviours of banking staff members and customers. On the other hand, if the consistency of behaviour is low, then the reasons are external reasons. This points out that if the level of control in the banking system is high, then moral hazard can be reduced.

The application of this theory in studying about moral hazard in banks suggests managerial implications. When violation of ethics occurs, we are inclined to ascribe an individual's behaviour to the nature of the person, that is, intrinsic factors. For instance, there are 2 banking staff members, one violates ethical standards while the other does not. Usually, we hastily conclude that the violating staff member is lacking in integrity, discipline and ethics, while the other receives opposite evaluation. However, the violating member is inclined to attribute the violating behaviours to external factors such as work pressure, low income or lack of management. Therefore, violating people usually lay the blame on external factors, while moral hazard in banks can occur if there is no rigid system of control. Therefore, the application of this theory can explain how similar violations of ethics cannot be understood similarly. From the factors ascribed to individual behaviours, risk managers will have different reactions to different individuals with the same violation of ethics.

Banking is a special business - money business. Therefore, moral hazard is not only commonplace but also occurs in many forms. Moral hazard can originate from any position in a bank, from administrators to staff members, from credit officers, supporting credit officers to bank tellers. Moral hazard in banks does not only result in financial losses for the bank itself and its customers, but also results in an explosion of risks and the collapse of the banking system as a whole. Therefore, studies about the basic theories of factors affecting moral hazard in banking operations are of paramount importance. However, each theory points out different aspects and different explanations of the reasons as well as the factors affecting moral hazard in banks.

### 3. Conclusion

To conclude, the majority of theories focus on factors such as behaviours, ethical standards, incentives, or other factors related to individual benefits. These theories have pointed out the important basis that lays the foundation for research on moral hazard. In addition, the theories have shed light on the formation and conditions for moral hazard in banks. The application of these theories in research on factors affecting moral hazard should be customized to each country with particular conditions for development. This helps managers establish appropriate risk management models, thus, promulgate and build policies and procedures that are suitable to practical conditions. In order to minimize risks, managers need to establish departments that specialize in risk management and build a rigorous procedure for controlling customers' cash flows, and scrutinize the procedures, the stages in the approval of profiles, all transactions must be completed in supervision. In order to predict moral hazard, customers' information must be compiled sufficiently and accurately, especially the appraisal of collaterals, interbank connections should be established to retain customers' information to predict risks and thus propose timely prevention. Banking is a field that requires a high level of clarity and professionalism. Therefore, the enhancement of staff members' competence is of great importance. Personal virtues and ethical conducts should be incorporated in the recruitment and training of staff members. Professional ethics should be prioritized in recruitment and should be regarded as a fundamentally strategic mission in the process of restructuring, and thus lay the foundation for sustainable development in the banking system.

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