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Some Background on Moral Hazard Management in Banks

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Abstract

The article focuses on researching the theoretical framework for moral hazard management in banks. With the desk research methodology, the content focuses on researching the overview of the concept and the causes of moral hazard, study of the theoretical literature related to moral hazard management and moral hazard management models in banks.

Keywords: Moral Hazard, Moral Hazard Management, Attribution Theory, Rational Action Theory, Process Justice Theory, Organizational Commitment Theory

1. Studies on the concept and causes of moral hazard

1.1. Concepts of moral hazard

In the early 1960s, discussions of moral hazard began to emerge in the field of economics, as study of decision-making under uncertainty increasingly (Dembe and Boden, 2000). According to Krugman (2009), moral hazard occurs when a person makes decisions or actions that benefit themselves while someone else bears all the losses if that decision or action fails. Retolaza et al. (2016) show that moral hazard is a type of market failure that arises in an asymmetric environment. Conflicts of interest may also exist within each management department (Kusairi et al., 2018; Mousa et al., 2019; Nier and Baumann, 2006). In addition, moral hazard is also a consequence of the conflict of interest between customers and service providers when there is information asymmetry (Xuan et al., 2021). At the same time, due to the separation of ownership, control and risk appetite of the participants (Eisenhardt, 1989; Jensen, 1986; Jensen and Meckling, 1976) it cannot be expected that the bank will not be interested in risk-taking and will always act for safety and sustainability, because risk and expected return are always opposite but unifying sides of every decision-making in business (Anginer and Demirgüç-Kunt, 2018; Cheng and associates, 2018; Girling, 2022). Since then, the consequences of asymmetry of information and interests in the process of operation are the cause of moral hazard in banking activities.

1.2. Causes of moral hazard

There are many causes of moral hazard. Jensen and Meckling (1976) or later Dembe and Boden (2000), Girling (2022) concluded that the main cause of moral hazard in the banking business is the asymmetry of information. Asymmetric information is the term refers to situation that management cannot be assured and cannot control over

the behaviors of their employees. Conversely, bank employees can also be affected by asymmetric information if management conceals the necessary information. Asymmetry causes stakeholders to act under uncertainty, which is undesirable for any party (Ahmad and Gao, 2018). Another cause mentioned is that the difference in interests exists, i.e. the banker exhibits opportunistic behavior to maximize his or her expected profit instead of acting in accordance with the bank goal. In addition, Prendergast (1999) argues that there is always an "imperfect contract" in a business relationship, therefore, it is very difficult to exist a clear type of contract that has all the benefits as well as required by the bank owner to ensure that employees will comply.

2. Study on novel theories.

When studying the intention or motivation to cause an action in an organization, including moral hazard, there are some novel theories as following:

Attribution theory was originated by Heider (1958) (quoted from Heider (2013)), and lately developed by Jones and Davis (1965), Bem (1972). The studies of Kelley (1967) and Kelley (1973) apply this theory to explain the causes of organizational behavior from two perspectives: managers and subordinates. This branch of research explains that the work motivation of employees will lead to certain orientations of managers (phase 1), then, managers will rely on those orientations to make decisions related to employees related to the behavior of subordinates (stage 2). Thus, the motivation for actions in the organization (including moral hazard) will first arise from the employees, but then be mainly influenced by managers. However, these theories are criticized that ordinary events do not create a basic motivation for workers to perform a certain action, but it must be unexpected events or failure situations (Weiner, 1985). Thus, attribution theory is one of the theories that can contribute to explaining the choice of a moral hazard management model from the representative side of the bank.

The Theory of Reasoned Action (TRA) by Fishbein and Ajzen (1975) answers questions related to human behavior in general. According to this theory, behavioral intention can be explained by attitude towards behavior and subjective normative level. Attitude to behavior is defined as an individual's positive or negative feelings about performing the target behavior, while subjective norm refers to how other people feel when you do something. The ultimate determinant of behavior is not attitude but behavioral intention. Therefore, this theory is often used to study the factors that cause criminal intentions - including issues related to moral hazard of the group of bank representatives. The biggest limitation of this model is that all behavior of an individual is due to his own reason. To overcome the shortcomings of the TRA model, Ajzen (1991) proposed a model (iii) Theory of Planned Behavior (TPB). The TPB model suggests that the most important factor influencing human decision making is behavioral intention. An extension of TPB theory when researching that attitude, perceived control behavior and subjective normative level have an influence on behavioral intentions and behaviors of individuals. Perceived behavioral control is added to show how difficult or easy it is to perform a particular behavior and whether or not the performance of that behavior is controlled. This theory is considered by some studies to be more optimal in explaining and predicting consumer behavior in a research content and context. Thus, this theory can be used to explain the intention to cause moral hazard behavior of bank employees; and a part to explain the choice of moral hazard management model of bank leaders.

The theory of procedural justice contributes to explaining a number of reasons why employees are willing to cheat in organizational matters (De Angelis and Kupchik, 2007; Nguyen Van Thang, 2013; Shapiro et al., 2007), 1995). When workers are not evaluated fairly, they will find many different ways to "regain justice". This problem is explained by the assumptions (variables) included in the model such as interaction attitude, information provision, opportunity to have a voice. And then, when there is a certain awareness, it has a positive effect on reducing the adverse risk of workers to the organization. This theory is put forward to evaluate ideas that are relevant to workers and middle or lower management. Therefore, this is one of the original theories introduced to evaluate moral hazard behavior in banks.

Organizational commitment theory. This theory suggests that employees in organizations often commit based on three components: emotional commitment (affective), utilitarian commitment (continuance) and normative commitment (mormative). (Meyer and Allen, 1991; Nguyen Van Thang, 2013; Allen and Meyer, 1996; Meyer et al., 1993; Meyer et al., 2002). In research related to individuals' commitment, their own unique problem is also

worthy of attention: if based on sentiment, there are personal characteristics and organizational structure of the business or job experience. If calculus is involved then there is a matter of investment, other options. Thus, studying the issue of moral hazard in the bank from the employee's side will introduce variables related to the personal experiences or calculations of individuals.

In summary, research on moral hazard usually has 4 main branches of the theory as above.

3. Moral hazard management model in banking activities

Due to the negative consequences and impacts of moral hazard toward the financial system and the economy, the establishment of a moral hazard management model becomes even more necessary in the future banking operations. However, the studies on moral hazard and the establishment of ethical risk management models in banks so far are limited.

The Basel Committee partly deals with moral hazard when classifying operational risks and operational risk events. Accordingly, the cause of operational risk comes from people with actions such as fraud, forgery, theft, improper activities, improper regulations or ineffective human resource management. According to the Basel Committee on Banking Supervision (Basel, 2006), operational risk management is defined as the whole process of continuously identifying, assessing, mitigation and monitoring in order to minimize the losses incurred during the implementation process and ensure business continuity of the bank (Do Hoai Linh et al., 2022). A key component of the operational risk governance framework is a set of core operational risk standards that provide guidance on the basis of control and assurance of the operating environment. Frameworks are complemented with different tools but all have the same main components: defining risk strategy (CLRR), building governance structure, establishing reporting lines, self-assessment controlling, managing risk events, setting-up key risk indicators (KRIs) and risk mitigation program (Girling, 2022). Operational risk – one of the specific risks that banks face is reflected in the framework of Basel II/III with 3 pillars according to which banks are expected to identify, measure and manage this type of risk: (i) Pillar 1 recommends that banks maintain a necessary amount of capital to deal with operational risks; (ii) Pillar 2 defines the review process of the organization's operational risk management framework and, ultimately, capital adequacy. Pillar 2 sets out specific supervisory responsibilities for the board of directors and senior management, thereby reinforcing the principle of internal control and other corporate governance by regulators around the world; (iii) Pillar 3 aims to strengthen market discipline through increased disclosure of information on operational risks, especially specific events that pose operational risks in banks. The operational risk management framework proposed by the Basel Committee includes the following steps: (i) risk identification; (ii) risk measurement; (iii) risk assessment; (iv) monitoring and (v) reporting. The Basel Committee also summarized 4 main issues including 10 principles in operating risk management and recommended banks to implement. Thus, moral hazard management from Basel's point of view has not been set out as a separate content, which is not suitable for the context of banks. It is necessary to properly recognize the impact of moral hazard in banking operations, from which, there should be a moral risk management model with a worthy position in banking governance.

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