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THE TWIN MORAL HAZARD AND THE ROLE PLAYED BY DERIVATIVES

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Abstract

During the financial crisis, public support became the standard response to save the banks in difficulty, heightening and broadening the moral hazard issue: subordinated/senior debt holders and large depositors were bailed out and equity holders were partially sheltered. The implicit promise to bail-out European governments in difficulty has encouraged SIFIs and other financial operators to speculate on the yield differential between sovereigns and the ECB money market rates.

Taxpayers of relevant countries became the unwilling insurers for banks and government liabilities in Greece, Ireland and Portugal. The ECB became the willing additional insurer of both banks and governments in danger, through (i) repurchase operations with banks with sovereign debt as collateral, (ii) direct purchases of public debt in the secondary market, (iii) money creation by GIPS Central Banks through the workings of Target-2 accounts (the real-time gross settlement system operated by the Eurosystem).

The relevant growth and spread of credit derivatives and many other OTC contracts trading contributed to fuel the systemic risks in the absence of an effective compensation system (e.g. the centralized counterparty systems (CCPs)), and monitoring.

Current difficulties in the global financial system are the result of not taken swift action on the fronts of control, regulation and monitoring of deregulated markets and operators. Policy suggestions are offered to reduce risk and moral hazard, in particular with respect to Credit Default Swaps (CDS) that represent a dangerous threat to financial stability.

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