

STORM WARNINGS

Vol. II, Issue 2: July 2013
Expectations & Behaviors: Moral Hazards



R. Michael Conley
Founder

The *Storm Warnings* newsletter is part of a larger initiative by its founder, R. Michael Conley, to carry the message to others.

"The message is frightfully simple: We are heading into a perfect storm that will forever change our lives, and we need to act on it while there is still time," said Conley.

Under the overall umbrella of his company, Weathering the Storm, LLC, its mission to *awaken, engage and help others weather the storm* is carried out in a number of ways.

Moral Hazards: Privatizing Gains; Socializing Risks

Moral Hazards are toxic contributors to the Perfect Storm. Highly contagious, they infect nations, institutions and individuals in insidious ways and intensify the storm's forces. In this issue, R. Michael Conley discusses the moral hazard phenomenon and contrasts it with the response of the "Greatest Generation" to the super-crisis of their time. Clearly, there is much we can learn from them as the perfect storm nears.

WTS: What is a "moral hazard" and why should we be concerned?

Conley: The term "moral hazard" refers to a situation where undue risks are taken by a risk-taker when they know there are few, if any, consequences for their actions. It is a self-perpetuating behavior that can provide significant upside rewards for the perpetrators while shifting the adverse consequences to others. In effect, the misaligned incentives allow offenders to privatize their gains and "socialize" – or hand off – the consequences to others.

The term itself gained notoriety following the bailout of banks deemed "too big to fail" in 2008, but the definition can be extended to include a host of behaviors that, in the aggregate, produce a huge drag on the entire system. Widespread and contagious, moral hazards are fueling the storm and hampering our ability to respond effectively to it.

WTS: Can you provide a few examples of how moral hazards have impacted the system?

Conley: The bank bailouts – prompted by a concern that their collapse would trigger an even greater economic disaster – left many feeling uneasy. They feared that banks would be encouraged to repeat the same risky behavior, once things got better, if they knew the government would assume the consequences of their actions; a moral hazard.

The sub-prime fiasco was a chain reaction of moral hazards that

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"The *Storm Warnings* newsletter, which provides an in-depth bi-monthly look at a specific topic, is one way we hope to awaken and engage people, but we encourage folks to log in to our web-site for a full menu of offerings and services," Conley said.

(www.weatheringthestorm.net)

The website will provide further details on other initiatives. Among them:

1. Lethal Trajectories – Conley's futurist novel on what it will be like to live through a perfect storm crisis
2. *Weathering the Storm Guide* – A guide on how to prepare for the storm
3. Weathering the Storm Seminars – In-depth seminars that are now available
4. Blog, links, other resources, and the Storm Warnings newsletter.

About the Founder: Mike Conley is the Founder of Weathering the Storm LLC, and currently serves as Chairman and CEO of the Conley Family Foundation. As a former Fortune 500 business executive, author, lecturer, and public policy

exploded across the entire financial services food chain. In this setting, profits were taken by the perpetrators and the risks handed off to others. It worked beautifully until it didn't, and the sub-prime crash that followed ignited a near global economic meltdown. Once again, the gains were privatized – enjoyed by a few, and the risks socialized – passed on to the general public in one form or another.

WTS: Is the moral hazard risk unique to the financial services industry or is it more widespread?

Conley: It's all-pervasive and takes many forms. For example, we squander finite resources and pay little heed to our carbon footprint – such as the twenty pounds of CO2 we put into the atmosphere for every gallon of gasoline we burn. The same moral hazard principal applies to the water we pollute, the aquifers we deplete, the staggering deficits we incur, the finite oil we lavishly use, and so on. In our pursuit of the good life, we've perfected the moral hazard credo that seems to say: "use now, pay later and shift the consequences to others." In many cases, the risk is shifted to the government.

WTS: It sounds like the government is the "risk-taker of last resort." True?

Conley: Let's first remember that we are the government. When the government takes on entitlements, debt, bailouts or other risks, we, the taxpayers, become the co-signers of those liabilities. Here's the rub: though we co-sign, we pass on our IOUs for others to pay. Mortgaging their future to support our current lifestyle is, to me, the ultimate form of a moral hazard.

That said, the government certainly has become the guarantor of last resort and it's happening at all levels of government. In doing so, we've made entitlement promises and guarantees we can't keep. Unsustainable – like a giant Ponzi scheme – it will be ugly for those left holding the bag. Is it any wonder that young folks today have little confidence in the viability of Medicare and Social Security when they retire?

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activist, Conley has written and spoken frequently on topics related to the perfect storm. He graduated from the University of Minnesota, after serving in the United States Navy, and later completed a post-graduate program at Stanford University. He is also active on several boards and advisory groups.

The list is long and it's easy to point fingers, but there's a little moral hazard in all of us. The truth is, whenever we renege on a student loan, file a false insurance claim, squander finite resources, pollute the environment, or game the system in self-serving ways – while passing on the consequences of our actions to others – we are infecting others with the moral hazard bug.

WTS: You have linked moral hazards to the perfect storm. How do they connect?

Conley: Well first, a quick refresher on the perfect storm: I'd define it as a collision of tectonic-sized forces with an explosive fury that could exceed the sum of all parts. For simplicity, I've

created a "4-E" perfect storm model that defines the forces as: 1) Economic, 2) Energy, 3) Environmental and 4) Expectation and Behavioral forces in play. In a structural sense, a moral hazard would fall into the latter category, but it has, in truth, a "multiplier" effect that intensifies all 4-E categories. Let's just call it a threat amplifier.

WTS: You praise the "Greatest Generation" and how they responded to their mega-crisis with an approach so antithetical to the precepts of a moral hazard. Care to explain?

Conley: The antithesis of a moral hazard-type response would entail things like good stewardship, personal accountability, shared responsibility, the Golden Rule or some such equivalent. It's about taking ownership for our actions and seeking shared solutions – as opposed to outsourcing both the efforts and consequences to others.

With respect to the Greatest Generation and their mega-challenge – the Pearl Harbor attack and America's subsequent participation in the most destructive war ever – their response was dramatic, effective and instructive.

Almost overnight, America's economy was transformed from a peacetime to a wartime footing. Fifteen million people were trained and put into uniform; America became the "Arsenal of Democracy" that armed the allied nations; the atomic age became a reality, and World War II was won. Further, America still had the economic power to finance the Marshall Plan that saved a devastated Europe; an incredible outcome in a short period of time.

WTS: How would you contrast their response to what seems to be our approach today?

Conley: Well first, they accepted the war as a shared national threat and took ownership for the

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outcome. Everyone contributed to the war effort. Gasoline, rubber, sugar, meat and other items were rationed. Kids collected pots and pans that were turned into weapons. "Rosie the riveters" transformed the American workforce and built the instruments of war while others were out fighting; war bond drives were conducted to help finance the war; taxes were raised and frivolities set aside to focus on the bigger challenge of beating the Axis powers. There was clarity of vision and partisan politics were minimized to accomplish wartime goals. Patriotism was a gut-level emotion – not a Pollyanna sound-bite voiced by a self-serving politician.

Contrast their approach to our recent wars in Iraq and Afghanistan. While the Greatest Generation tried to finance their war on a pay-as-you-go basis, we opted instead for a play-now-pay-later approach that treated most of the wars as an off-balance sheet expenditure. Over a trillion dollars of debt was passed on to others with nary a thought given to the consequences.

Our approach to a debt-laden economy is another example. Politically easier, it seems, to "print" money than raise taxes or cut expenses. Our gridlocked political parties are obsessed with winning the next election while Wall Street fixates on quarterly earnings versus strategic necessities. The Greatest Generation accepted ownership of their challenges; we've opted for pain-free fiscal and monetary policies that will only defer the day of reckoning. That's what moral hazards are all about, and they are imposing a huge drag on our entire system.

WTS: What can be learned from the approach taken by the Greatest Generation?

Conley: There's good and bad news: The good news is we're capable of mitigating the sharper edges of the storm with an engaged citizenry that is willing to reject moral hazard-ism as a preferred solution. The bad news is we've shown little propensity to change our behaviors. That said, there are at least three important lessons we can learn from the Greatest Generation:

1. Transformational vision: Great challenges require a compelling vision that transcends all hardships and inspires ordinary folks to do extraordinary things. Winning the war was their cause; could saving the planet be ours?
2. Facing reality as it is: The Greatest generation was clear on the immensity of the challenge and responded accordingly. By contrast, we've yet to awaken to the threat of the perfect storm. Their catalyst was Pearl Harbor; what will it take to ignite our fuse and awaken us?
3. Totality of effort: WW II required a total effort with everyone sharing in the solution. Tough calls were made and acted upon with resolution. Can we overcome our addiction to moral hazards and work together or are we consigned to an ugly fate of our own making?

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WTS: Any closing thoughts on the situation or what we can do about it?

Conley: Situation-wise, this country was built on the American Dream, but the dream enablers – cheap energy, abundant resources and a can-do spirit – are disappearing. The perfect storm, in its totality, will require a robust response of WWII proportions. In this respect, there is much we can learn from the Greatest Generation. The moral hazard approaches in vogue today, though creating an illusion of well-being, are fleeting panaceas that cannot sustain the unsustainable. Indeed, they are actually exacerbating the threat.

Quite honestly, I'm not sure we'll find the national resolve to respond while there's still time. More likely, the situation will deteriorate to a point where solutions will be forced upon us. Let's be clear; we are not victims and we have choices. We can either wait for our political leaders to respond – an unlikely scenario – or we can act now to develop our own Plan B.

Plan B is antithetical to the moral hazard strategies that do little more than "rearrange the deck chairs on the Titanic." It should be a grassroots plan for households and communities that focus on reducing our reliance on systems we can't control, improving our self-sufficiency skills, learning to live with less and getting positioned for the perfect storm as best we can.

At first blush, it's a daunting challenge, but I have prepared a free *Weathering the Storm Guide* that readers can download. The Guide provides an action blueprint with practical ideas for preparing a personalized Plan B. It will help readers to: a) awaken to the realities of the perfect storm, b) engage by developing a personal action plan, and c) leverage activities with others in a meaningful way.

As a pragmatic businessman, I've learned that you can't resolve problems by denying their existence or sweeping them under the rug. We can do better, and I encourage readers to start now by visiting my website and downloading my free Guide: www.weatheringthestorm.net