Moral Hazard

(adapted from Wikipedia)

A moral hazard is a situation where a party will have a tendency to take risks because the costs that could result will not be felt by the party taking the risk. In other words, it is a tendency to be more willing to take a risk, knowing that the potential costs or burdens of taking such risk will be borne, in whole or in part, by others. Economist Paul Krugman described moral hazard as "any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly."

Financial bailouts of lending institutions by governments, central banks or other institutions can encourage risky lending in the future if those that take the risks come to believe that they will not have to carry the full burden of potential losses. Lending institutions need to take risks by making loans, and usually the most risky loans have the potential for making the highest return. So-called “too big to fail” lending institutions can make risky loans that will pay handsomely if the investment turns out well but be bailed out by the taxpayer if the investment turns out badly.