


# Chapter 5


## Moral Hazard in Capital Market: A Comprehensive Study

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### ABSTRACT

*Moral hazard was originally a term used only in the field of insurance, but it has since entered capital markets, changing incentives and increasing systemic risk. This literature review confronts how information asymmetries, governance risk, and implicit guarantees create opportunism for managers, investors, and institutions. A systematic review of the existing literature that is reflected in 51 peer-reviewed articles reveals four themes: amplification of risk, misalignment of incentives, ethical governance, and institutional design. The review also identifies three major gaps: the neglect of the investor side, lack of consideration for the Corporate Social*

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*Responsibility (CSR) framework, and lack of methodological innovation. This paper calls on researchers from various disciplines to examine moral hazard to better develop the literature and construct a more robust market.*

## **1. INTRODUCTION**

The term “moral hazard” has received a lot of attention in economics and finance. It started as a concept in insurance. Moral hazard described cases where the insured changed their behavior to take more risks because they knew they would not fully face the negative outcomes of their choices (Arrow, 1963). Since then, it gained a broader definition. It incorporated a number of new economic transactions, like those with information asymmetries and problems of principal agents (Holmström 1979). Given the increasingly complicated nature of capital markets, characterized by complex financial product development, multi-actor participation, and international pressures, moral hazard is as important as ever. The separation of ownership and control, the evolving regulatory landscape, and the pursuit of short-term profit render capital markets particularly susceptible to moral hazard.

According to the Classical economic theory, Moral hazard has been described as a problem that usually occurs after completing a transaction. At this point, one party can change its behavior based on the contract. While insurance created the earliest context for studying the issue, as trust, transparency, and credible commitment became central to the problems involved, financial markets shortly thereafter became a rich area to study the implications of moral hazard.

Moral hazard takes several forms in capital markets. For example, corporate managers may use accounting practices to inflate stock prices because most stockholders are unable to effectively observe their management (Jensen & Meckling, 1976). In addition, banks and financial institutions may have an over-lending problem as they are dependent on the government's role as a systemic safety net (a clear exposé of this was highlighted during the global financial crisis) (Acharya et al., 2011). These examples emphasize that moral hazard is definitely a real explanation for instability in the financial markets and not just a theoretical problem.

Capital markets like stocks, bonds, and derivatives are very important for today's economies. They allow money to flow where it needs to go, give regular people access to investments, and keep things moving. But the very things that make them work well can also make them risky. Things like who owns public companies, using lots of borrowed money, and confusing deals that hide risks can create chances for people to act unethically.

Investment banks, for example, may create structured products that yield short-term profits for investors but dissimulate long-term risks, transferring risks to

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