

Hazardous Immorality: Strategic Externalization of Risk and Credit Pricing

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Abstract: In this study we examine the risks caused by “hazardously immoral” contracts which force external parties to bear significant losses without their consent. The expectation of substantial future losses raises the question of how investors can become profitable by entering into such risky contracts. We investigate the use of such contracts, which obscure the expected cost of failure by not only concentrating risks but ultimately not taking routine charges for predictable, albeit uncertain, future losses. In our investigation, we look at a risk concentration strategy and discuss expected profits (losses) under conditions of limited and unlimited liability. We find that companies are more likely to minimize losses and maximize profits if they can obtain credit at a low enough interest rate and externalize the majority of the risk. Risks are more likely to be externalized when government and/or international agencies bail out the offending organizations to limit total damages and stabilize the economy. The main contribution of this paper is to show that a risk concentration strategy can be used to make the overall probability of winning arbitrarily large, even when individual trials have less than a 50 percent chance of obtaining positive profits. The corollary lesson is that credit is valuable, and having substantial credit obtainable at low rates is so valuable that significant gains are probable despite negative expected profits.

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