Moral Hazard

by Anne Emerson

There's a concept in Economics known as "Moral Hazard." It is highly relevant to insurance markets, but it can apply in general as well. The first time I heard about it, I didn't think it was a moral issue; rather it was a logical one. But I am older now, and I have a better grasp of what morality is. That will be addressed under the link for "self and society" on this website. (Anniespicsandpoems.com) My website is not selling anything (as of now), it's just that "local artists" get set up as .com by their IT gurus. Although art is my hobby, I am trained as an economist.

Let us suppose, for example, that we are an insurance company offering flood insurance. The idea behind insurance is that you pay the insurance company a fee (called a premium), against the unlikely chance that there will be an accident or damage to something you value. If lots of people do the same thing, then the insurance company has enough money to pay out, to the people who are unlucky enough to suffer the (unlikely) accident.

For example, a business offers flood insurance on personal residences at, say, $10 per month. People who don't think their homes are likely to be flooded probably won't buy flood insurance, even at the bargain price of $10 per month. People who think they are very likely to be flooded will likely jump at that rate. Repairing a flooded house may cost $100,000 or more. You would have to live in that house for way more than 1,000 years before it's not a good deal to insure it. ($10 per month for 1,000 years is $120,000. That is, $120 per year, for 1,000 years.)

Offering insurance is a business matter. That is, we have to bring in more money than we give out, in order to stay in business. So, insurance companies hire people who can calculate the odds of accidents. These odds help managers decide what rates to charge to their customers. Here is a different example, that can help explain about the use of statistics in the insurance business:

This "example" insurance business offers life insurance. Since people die eventually, the older a person is when they first take out life insurance, the higher the premium will be. In my family, both my husband and I had life insurance while our children were small. If something had happened to us, that insurance money would have helped our children to manage, financially, without our paychecks. We also saved money for retirement. Eventually, our children grew up and became self-sufficient, and we had saved enough that we could probably finance our later years. So, we stopped buying life insurance. That is how we avoided having to pay very high premiums as we grew older.

The calculation that the insurance company's statistical experts would have to make centers around the number of likely customers (premium payments coming in), the likelihood that the insured customers would die young (likely numbers of payouts to relatives of deceased customers), and the amount of the payout (dollar value of each payout to relatives of deceased customers). Clearly, we can be quite inventive in our business model, and most insurance companies indeed are.

But if our statisticians make a statistical mistake, not only might we pay out more than we can afford to pay out, but also our other good paying customers will suffer when we go out of business. They will have paid their premiums, but the benefit they have paid for will no longer be available to their relatives in case of their own accident.

The degree of moral hazard here is quite complex. I expect most of you have heard of cases where someone's life is insured one week and they die the next. Police are likely to be called in, because this is mighty suspicious. Or, let's say that people live in a toxic (poisonous or violent) neighborhood. Then the statisticians might miscalculate the odds of early death. Then, the insurance company, having paid out "too much" in that neighborhood, has seen what is going on and might refuse to insure residents of such a neighborhood. Or, they might put the premiums up in that neighborhood. Or, they might make an unreasonable excuse not to pay out, when something happens.

Residents of such neighborhoods probably want accident insurance more than residents of other neighborhoods. This can lead to a vicious cycle. The more challenging the neighborhood, the higher the premiums and the less the residents can afford them. Before you know it, you are paying "danger money" to your local gang leaders for their protection of you against other gangs.

This situation is not inevitable, but very often it can be the consequence of a downward spiral that begins with a financial event that was nobody's fault. I was not alive during the Great Depression, but that was such a shock to so many people that governments tried to put systems and processes in place to avoid having anything like that happen again. Analysts tried to understand how this had arisen in the first place.

Financial crashes were part of the business world for many centuries. They still are, in some places. Well, I have strayed far from the original intent of this essay.

Point is, insurance markets depend on the good faith of all parties – we customers shouldn't request payouts when we don't deserve them. Insurance companies shouldn't make excuses not to pay out when there has been a deserving accident. Insurance valuers should not value an asset so highly that it is worth more to the customer lost or damaged than intact. Etcetera.

The particular issues that are changing rapidly and "busting" statistical analysis of insurance markets – both business and personal insurance – include: environmental change (fires, oil spills, floods, to name a few); health insurance (obesity, cancer, expensive machines prolonging life at great expense); pollution (people breathing toxic air or eating food sprayed with insecticide); and expensive lawsuits. One reason for "national health insurance" is that we want everyone to pay into the insurance coffer so that the most seriously ill people can be covered. Obviously, the least ill people resent this. UNTIL they get ill themselves. Then again, if the government covers everyone, a whole industry can arise around making people ill and snatching the government's money in the name of helping out!

To summarize – moral hazard is the idea that people "game" insurance markets. To some extent this is human nature, but I don't think we want to look the other way when we see it happening. In order to turn it around, we can perhaps start with small changes at the local level where the stakes are not so high, but we should be aware that a hundred small attempts to be good can be wiped out by ONE large corruption. Tolerating large corruptions will make some people very angry.

This essay is not going to explore the complexities of unraveling layer upon layer of culpability. For example, if we are not careful, we may see the wrong person punished too harshly and a worse villain going free. This sort of thing has to be left to experts. We can help by not getting too cynical. Me, I am old enough to "watch" everything, but believe it or not, I am STILL slow to pass judgment