RECESSION LESSON:

My gain, your pain: Consequences of moral hazard

DEFINITION:

Moral hazard means that **people with insurance may take greater risks** *than they would do without it because they know they are protected* (The Economist, www.economist.com/research/Economics).

Moral hazard describes **behavior where agents do not bear the full cost of their actions** *and are thus more likely to take such actions* (Organization for Economic Cooperation and Development (OECD), http://stats.oecd.org/glossary).

Explanation of moral hazard

We all learn relatively early in life that actions have consequences. Sometimes consequences are pleasant, such as an extra perk at home for taking out the trash without being told. Of course, there's the flip side; if you talk back to adults or break your curfew, you might experience a penalty. But what would happen if you knew there was little to no chance of a negative consequence for your decisions? Would this cause you to modify your behavior?

Moral hazard can occur when a person or organization doesn't face all the consequences of their actions. As a result, they may be more careless or reckless in their behavior. Those with limited responsibility for the clean-up may not be as concerned with the total size of the mess.

Role of moral hazard during the recent recession

"Too big to fail" was a common buzz phrase during the recent recession, and the concept is actually an example of moral hazard. The idea behind "too big to fail" is that certain businesses are so important to an economy that disastrous consequences would result if they were allowed to fail. This was the rationale behind the Federal Reserve providing assistance to Bear Stearns, a cash-strapped investment brokerage, and American International Group (AIG), a global company heavily involved in insuring against debt defaults. Many thought that without Fed intervention, our economy as a whole could have been brought it its knees through financial market collapse.

There are smaller-scale examples of the potential ripple effects of a business failure. Imagine the only grocery store in an isolated small town going bankrupt through poor business practices. In a market economy this is common; businesses fail all the time for the same reason. But things become more complicated when you consider the impact on residents who would now have to drive 50 miles to get groceries. The importance of the grocery store to the community might lead the local banks to loan money to save the store. This concept, on a much larger scale, influenced the decision to save Bear Stearns and AIG. The Fed could have allowed the institutions to fail and the country to pay the price. Instead, it chose to cushion the impact of reckless decision-making for the stability of the country's economy.

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Lessons learned about moral hazard

One method to combat moral hazard is to proactively limit the circumstances in which it might occur. A solution in the financial sector might be to break up large interconnected financial and nonbank institutions that could cause widespread chaos through risky business transactions. Think of climbing a mountain while tethered to other climbers. If a climber starts to slip, the others in the line must save him so they won't be pulled down. Getting rid of the tether causes everyone to take more responsibility for making sure they have a sure footing.

As a result of the financial crisis, new regulations require increased supervision of financial and nonbank institutions. The regulations use tougher standards to assess risk in lending and in developing complex financial products to offer investors. More examinations will ensure that firms' business dealings are more transparent and risky actions are minimized.

While it can have a negative impact, moral hazard could be averted if institutions in trouble are simply allowed to fail. There are plenty of negative side effects from a failing institution, but it is the way the market is intended to work. If no one is there to cushion the fall, there is less incentive to participate in risky behavior without willingness to suffer the consequences.

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The danger of moral hazard is that these rescues could be viewed as a precedent for aid in the future. The more institutions are insulated from risk, the more they might be tempted to repeat risky behavior. The Fed imposed tough terms for the bailouts - it demanded collateral for the loans and charged interest at high rates. But will these actions be enough to keep moral hazard at bay in the future?

Examples of moral hazard in the insurance industry

It's easy to only think of moral hazard as a distant concept, but in all actuality it is a lot closer than you might think. Insurance, in many forms, is linked to moral hazard because the insured party becomes insulated from risk due to their coverage. In fact, the phrase moral hazard appears to be born out of the insurance industry in the mid-19th century.*

Insurance companies want to grant coverage so they can collect income from insurance premiums, but they also want to pay as few as claims as possible. They use the underwriting process, which assesses the risk of potential policyholders, to try to meet these goals.

Policyholders, however, may behave differently once they receive the insurance policy because they are at least partially insulated from the risk. For example:

- Although you pay the insurance premium and face paying a deductable if you have a claim, you might drive more recklessly after purchasing car insurance because you won't be fully financially liable if you get in an accident. You end up taking more risk than what you did without the insurance.
- Once you receive health insurance, you may start going to the doctor more frequently for more minor problems. You pay the insurance premium and co-payments for the office visits, but you're not fully responsible for the cost of your healthcare.
- Disaster insurance might reduce your perceived risk of building a house in a flood plain or brushfire area because the policy will cover the value of your home and belongings. Once again, you have to pay the premium, as well as the deductable if your house is damaged, but the insurance policy might result in you buying a house in an area you would never consider otherwise.

*http://www.nytimes.com/2008/04/06/magazine/06wwln-safire-t.html

RECESSION LESSON LEARNED: MORAL HAZARD

Activity 1

Give the following scenario to students as background for a debate on the topic of moral hazard: Imagine our school has just instituted a new grading policy titled "Too Safe to Fail." All students who attend, complete assignments and take tests will not fail their class. Individual grades for these assignments and tests will not be given. The grading system for this policy will be pass/fail only. As long as students consistently show effort, they are guaranteed not to fail their classes. This policy should result in more confidence and self-esteem for students, as well as less work for teachers in scoring papers and assigning grades.

Divide students into two teams to debate the pros and cons of this grading scenario. Use the statement, "Resolved: No student will receive failing grades if they show effort by attending class and completing all class requirements." Those arguing the affirmative will want to stress the added confidence of students and the ease in grading. Those arguing the negative will want to bring up the issue of moral hazard: will students slack off, knowing they are protected from failing if they do the minimum? Will overall academic ability decline due to less studying in all subject areas? Students should prepare two minute arguments and debrief after the debate.

Activity 2

Focus on the BP oil spill in the Gulf of Mexico as a disaster that may have moral hazard implications. Watch the "60 Minutes" video, "Blow Out Preventer May Hold Clues to Oil Spill," or read the text highlighting the disaster: http://www.cbsnews.com/stories/2010/09/05/eveningnews/main6838077.shtml?tag=cbsnewsMainColumnArea.

Discuss that when the Oil Pollution Control Act of 1990 was passed, it set up a trust fund to cover the costs of cleanup and damages over $75 million. BP will not be liable for costs over this amount even though the overall damages will extend into the billions of dollars. Any additional funds BP contributes towards the disaster will be considered voluntary.

Use the following discussion questions:

- Do you think the Oil Pollution Control Act creates a moral hazard situation for oil companies? Give reasons for your opinion.
- The trust fund will pay out damages from oil drilling without looking to see if the company was negligent or careless in its practices. Does this policy discourage oil companies from trying to prevent spills?
- BP's reputation has been hurt as a result of the oil spill. Do you think the potential loss of an oil company's reputation is enough of an incentive to keep these companies from careless practices?
- Are fines sufficient to punish the companies that have caused environmental damage through oil spills? Should prison time be given to company executives who made the risky decisions in order to lessen the influence of moral hazard?