Behavior and insurance: The problem of moral hazard

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Insurance affects human behavior in what has been termed as moral hazard. Each individual responds to insurance in various ways. In turn, insurance companies initiate countermeasures to respond to the insureds behavior. Moral hazard is the “name given to the negative behavior that can arise from an individual being insured.”

Moral hazard has been given several definitions. Its origin can be traced to its wide usage in the insurance industry in late 1800s. Since then, it has been used with different connotations in other fields. Moral hazard is the “circumstance that increases the probability of occurrence of a loss, or a larger than normal loss, because of a change in an insurance policy applicant’s behavior after the issuance of a policy. It may be due to the presence of incentives that induce the insured to act in ways that incur costs that insurer [but not the insured] has to bear.” It is “a situation in which one party gets involved in a risky event, knowing that it is protected against the risk and the other party will incur the cost.” Thus, under certain circumstances, “individuals will alter their behavior and take more risks.” Moral hazard “occurs when the party with more information about its actions or intentions has a tendency or incentive to behave inappropriately from the perspective of the party with less information.”

Renowned economist Paul Krugman defines 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.” It has been defined as “the tendency of insurance protection to alter an individual’s motive to prevent loss. This affects expenses for the insurer and, therefore, ultimately, the cost of coverage for individuals.”

The underlying premise of moral hazard is that a person “that is protected, in some way, from risk will act differently than if they did not have that protection.” Specifically, “insurance companies worry that by offering payouts to protect against losses from accidents, they may actually encourage risk-taking, which results in them paying more in claims.” In other words, it is the “don’t worry, it’s insured” mentality.

Moral hazard may arise under two conditions: 1) there is information asymmetry where one party holds more information than the other; and 2) a contract affects

the behavior of two different parties. Moral hazard is driven by “asymmetric information.” Using health insurance as an illustration, asymmetry occurs “because the insurer has less information about the health status and reasons for health-care usage of the insured than the insured themselves do.” Thus, risks may arise or increase without the insurers knowledge. And this added risk is not priced into the insurance contract.

There are three types of moral hazard: ex ante moral hazard, ex post moral hazard and insurance fraud. Ex ante moral hazard is known as an “insurance-induced increases in risk-taking.” It espouses that “people engage less in preventive behaviors that are costly and hard to maintain when they obtain insurance.” It (taking in more risk) occurs before an incident or loss takes place. Hence, ex ante. It has been suggested, however, that ex ante moral hazard is largely theoretical and that few empirical investigations have been conducted to support this theory. In a study by Courbage and de Coulon in 2004, using data from the British Household Panel Survey, it was concluded that “people with private-insurance coverage are more likely to exercise and are less likely to smoke.” A study by the Network for Studies on Pensions, Aging and Retirement (Netspar) concluded that “insurance does not seem to cause excessive risk-taking.” Rather, “ex ante moral-hazard effects are only found for preventive behaviors.” Meaning, an insured “is less likely to take his vitamin pills when he obtains insurance—but not that he would start to smoke or use drugs.”

Ex post moral hazard, on the other hand, espouses that there is an “insurance-induced increases in usage of insured services.” There is an “increase in people’s use of a service when it is covered by insurance, compared to when it is not.” Thus, people who have health-care insurance are more likely to visit a doctor, compared to when they do not have health-care insurance. Insurance “removes all or part of the incentive to restrict the use of insured services.” It occurs after an incident has taken place. Hence, ex post.

Insurance fraud also stems from asymmetry of information “where the policyholder abuses the trust that the insurer is obliged to place in him or her.” The Insurance Information Institute, a US industry association, has estimated in 2010 that 3 percent to 10 percent of US health-care expenditures are due to fraud, equivalent to about $77 billion to $259 billion.

Insurance companies have responded to the presence of moral hazard by: 1) adding incentives and 2) penalizing bad behavior. Incentives are illustrated when insurers will not insure for the full amount or providing incomplete coverage against loss or when insurers make it difficult to make claims. Thus, the insureds should share in the cost of hazardous or risky behavior. In motor-car insurance, there are the deductibles. The car owner must pay for some or all of the damages. Other risk-reduction incentives include exclusions and experience rating. Insurance companies also use actuarial databases in underwriting.

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