

## Moral Hazard

Talk given by Mary An Godshall on Sunday, March 15, 2009

When the financial meltdown was becoming evident in 2008, we began to hear the term **moral hazard** a lot. I had never heard of it before and was curious as to what it meant. Recently I heard a news reporter say, “forget moral hazard, we are so far beyond that, we just need to fix the problem.” In the span of about 6 months, according to this reporter, we went from worrying about moral hazard to being in so much trouble, we could not afford to worry about it anymore.

So what is moral hazard? It was a bit strange to all of a sudden be hearing this term banded about so much.

**In the most simple of terms, moral hazard means "encouraging bad behavior in the future."**

The term was widely used by English insurance companies in the late 1800s. Early usage of the term carried negative connotations, implying fraud or immoral behavior (usually on the part of an insured party), and still does today.

**Wikipedia definition:** Moral hazard is the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk. Moral hazard arises because an individual or institution does not bear the full consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear some responsibility for the consequences of those actions.

According to Wikipedia, moral hazard is related to information asymmetry, a situation in which one party in a transaction has more information than the other. The party that is insulated from risk generally has more information about its actions and intentions than the party paying for the negative consequences of the risk.

Moral hazard is also related, in my personal opinion, to a tendency by some to expect the absolute worst of people. By “some”, I mean people in power, those who get to make the rules.

**In insurance markets**, moral hazard occurs when the behavior of the insured party changes in a way that raises costs for the insurer, since the insured party no longer bears the full costs of that behavior. Because individuals no longer bear the cost of medical services, for example, they have an added incentive to ask for more expensive and elaborate medical service – which otherwise would not be necessary. In these instances, individuals have an incentive to over-consume, simply because they no longer bear the full cost of medical services. At least, that is the theory. In reality, it happens, but is not universal.

**Health policy.** In an article in *The New Yorker* on August 20, 2005, **Malcolm Gladwell**, stated that America's health-care mess is, in part, simply an accident of history. The fact that there have been six attempts at universal health coverage in the last century suggests that there has long been support for the idea. But politics has always gotten in the way. In both Europe and the United States, for example, the push for health insurance was led, in large part, by organized labor.

But in Europe, the unions worked through the political system, fighting for coverage for all citizens. **From the start, health insurance in Europe was public and universal**, and that created powerful political support for any attempt to expand benefits. *(It would be like a politician in the United States being against Social Security or Medicare – immediate political suicide.)*

In the United States, by contrast, the unions worked through the collective-bargaining system and, as a result, could win health benefits only for their own members. **Health insurance in the United States has always been private and selective** *(and almost exclusively associated with employment)*, and every attempt to expand benefits has resulted in a paralyzing political battle over who would be added to insurance rolls and who ought to pay for those additions.

Gladwell continues to say, policy is driven by more than politics, however. It is equally driven by ideas, and in the past few decades a particular idea has taken hold among prominent American economists which has also been a powerful impediment to the expansion of health insurance. The idea is known as “moral hazard.” Health economists in other Western nations do not share this obsession. Nor do most Americans. But moral hazard has profoundly shaped the way think tanks formulate policy and the way experts argue and the way health insurers structure their plans and the way legislation and regulations have been written. The health-care mess isn't merely the unintentional result of political dysfunction, in other words. It is also the deliberate consequence of the way in which American policymakers have come to think about insurance

**In management**, moral hazard can occur when upper management is shielded from the consequences of poor decision making. Does this make you think of the huge bonuses executives get even when their stock price has tanked, or the golden parachutes they get after they leave the company they have wrecked?

**In finance**, bail-outs of lending institutions by governments, central banks or other institutions can encourage risky lending in the future, if those that take the risks come to believe that they will not have to carry the full burden of losses. Lending institutions need to take risks by making loans, and usually the most risky loans have the potential for the highest return. A moral hazard arises if lending institutions believe that they can make risky loans that will pay handsomely if the investments turn out well but they will not have to fully pay for losses if the investments turn out badly. **Essentially, profit is privatized while risk is socialized.** Taxpayers, depositors, and

other creditors have often had to shoulder at least part of the burden of risky financial decisions made by lending institutions. Remember the Savings & Loan debacle of the 1980s? We certainly saw that recently with the executive who received bailout money and then gave themselves and their associates millions, even billions, of dollars in bonuses, as well as elaborate parties and trips.

And how about **life insurance**? Now if there is a moral hazard if ever there was one (to the beneficiary) and a physical hazard to the insured! It has been the basis for untold murder mystery novels.

**Paul Kedrosky**, a writer, CNBC analyst, Senior Fellow at the Kauffman Foundation, and frequent contributor to NPR, stated in an article on March 27, 2008, I keep wondering about the consequences of all this chatter about "moral hazard". **Because the trouble is, moral hazard exists many times we do anything to prevent someone from suffering, but that doesn't mean we shouldn't do it, nor does it mean we should moralize about moral hazard every darn time.** You could easily imagine a reverse situation taking hold, one where we're so afraid of taking action, because of "moral hazard", that we're frozen into inaction when we should just be getting on with things.

Paul Kedrosky finishes his article by saying, There has been a huge upswing in Google searches for "moral hazard." In case you're wondering, most of the moral hazard searching at Google is coming from Singapore, Switzerland, Austria, Taiwan, and Germany. Damn moralizers. The U.S. is only eighth on the list.

## **D**IFFERENCE BETWEEN ETHICS AND MORALS

Talking about "damn moralizers", this brings me to the second part of my talk. I got to wondering about the difference between ethics and morals.

The difference between ethics and morals can seem somewhat arbitrary to many, but there is a basic, yet subtle, difference. Morals define personal character, while ethics stresses a social system in which those morals are applied. In other words, ethics point to standards or codes of behavior expected by the group to which the individual belongs.

I think also that in our modern society, to talk about morals and morality seems judgmental, and that is bad. But to talk about ethics is all the rage, it is good to be ethical, but one should not moralize too much.

Ethics comes from the Greek word *ethos*, which means character, custom, a person's normal state. So it is very interesting that ethics derives from the idea of a **person's normal state**. Thus, basically, ethics is the concept that humanity's normal state is to do the right thing.

**Dr. P.M. Forni**, Harvard professor and founder of the “Civility Project”, in an article on the CNN website (2008) talks about the principle of respectful persons with regard to ethical behavior. He says, "The principle of respectful persons is the principle upon which all ethical systems have been based from the beginning of humanity, since certainly the last 2,000 years." "This principle says that we ought to treat others as ends in themselves rather than as beings for the satisfaction of our own immediate needs and desires." This fits very well with our Unitarian Universalist value of recognizing the worth and dignity of every person.

### **Is the Golden Rule really the only rule you need for living right?**

The word **moral** arises from the Latin word *moralis*, which means pertaining to **manners**. Morals are defined as principals and practices regarding right, wrong and duty; ethics; general conduct or behavior. Another dictionary definition is much simpler – capable of making the distinction between right and wrong in conduct.

So morals are the same as manners? And morals and ethics are the same thing? Maybe yes and maybe no. In a perfect world I think morals and ethics would be the same thing, and we would all know what was the right thing to do. In real life, morals and ethics often clash, and sometimes we don't know what is the right thing to do. Sometimes it really is a decision between two bad choices – you pick the one that you think does the least harm.

So our understanding of the word "moral" is relating to, or capable of making the distinction between right and wrong. Easier said than done in some situations.

In society, we are all faced with the butting heads of ethics and morals. Abortion is legal and therefore medically ethical, yet many people find it personally immoral. Fundamentalists, extremists, mainstream theists, not to mention humanists, Unitarians, etc., all have different ideas about morality that impact each of our lives.

**The first hallmark of moralization is that the rules it invokes are felt to be universal.** This idea of a universal moral law has preoccupied philosophers since the beginning.

But there is no question that the idea of what is moral (or ethical) can change with time or with the society. **So is it really universal?**

What was considered amoral can become immoral: Smoking, for example; for some eating meat is immoral or unethical based upon either religious or environmental grounds.

What was once considered immoral is now acceptable: Divorce, working mothers, birth outside of marriage, sex outside of marriage, homosexuality, cohabitation. A last outpost is gay marriage, which is slowly moving out of the sphere of being called immoral toward acceptance.

Philosophers have been struggling with the human moral sense for centuries. Is it really universal, how is it known, where does it come from? Plato, Aristotle ....right from the start, this has been a major concern of philosophers.

In the late 1780s, Emmanuel Kant wrote, "Two things fill the mind with ever new and increasing admiration and awe, the oftener and more steadily we reflect on them, the starry heavens above and the moral law within." Kant argued that our moral obligations in the final analysis derive from reason by recognition of the moral law, and not from God, nor from communities, nor from inclinations or desires.

Darwin himself believed that the moral sense or conscience is by far the most important distinction between humankind and other species (1871).

One of the strongest advocates of this position was the man Darwin honored as "our great philosopher," Herbert Spencer. Spencer argued that it was clear that we are possessed of an intuitive capacity for making moral judgments and, further, that this capacity must be the product of the evolutionary process.

Steven Pinker says that the **human moral sense** turns out to be an organ of considerable complexity.

**Is it ethical to be anonymous?** If you read forums on the internet, you will soon find that the art of the insult is alive and well, thanks to anonymity. Is it okay to say any horrible thing you want to the other person's comment, just because they will never know who you are? **Is it moral to be anonymous?**

What about pharmacists who refuse to fill a prescription? This is the imposition of personal morals in the public sphere. Should it be allowed?

Is it ethical for a news reporter to watch a crime and not do anything because he is reporting it? Is it moral?

**Is the Golden Rule really the only rule you need for living right?**

**Is it moral to eat a steak? That is a topic for another sermon.**

I will end with two quotes that sum up this talk. Forget for a moment about the fine distinctions between ethics and morals, the moralizing of moral hazard, and just remember this:

From Jordan Van Voast: **"The foundation for any vibrant civilization includes a just and compassionate society which nourishes the body, mind and spirit."** (Van Voast is the

founder of Acupuncture without Borders, who spent time in New Orleans after Katrina, ministering to first responders, quoted in a Times Picayune article from February 2006.

From Dr. Forni: **"The quality of our lives is about treating each other well in every situation. We are all the trustees of one another's happiness and well-being in life."**