Free essay about moral hazard

Business, Company

Moral hazard means the tendency of parties to take risks believing that they don’t have to pay to pay for the results of their actions. The idea that a person is protected in a certain way from the risk will make them act differently as opposed to when they didn’t have that protection. Insurance companies, therefore, worry that by compensating people to protect them from losses, they may be actually encouraging high-risk behaviors. This results in the insurance company paying more in claims. Simply put, neither the consequences nor the cost will be felt by the policyholder.

The scenario I was in is when as an insured individual, I had a much more information about my health than the insurance company. Therefore, after contracting for insurance, I could use that information superiority to change my behavior in a way that benefits me. Because the cost of my healthcare is being paid for by a third party, I have an incentive not to use health care less economically. As an insured person, I have less motivation to take care of myself and adopt a healthy lifestyle so as to avoid the need for health care. The primary dimension of moral hazard in this scenario results from the behavior and actions of the insured. It is like the insurance discourages the insured person from taking preventive measures. There are expenses involved when taking precautions to avoid unforeseen loss. However, individuals who are fully insured see no reason to bear these costs since their insurance will fully cover the cost. This encourages the insured to behave recklessly.

Moral hazard is, therefore, the health care needed by a party that is insured because of failure to take preventive actions so as to avoid the care. Insurance may also encourage the insured to obtain unnecessary health care. The existence of insurance involves the concepts of shifting risks and spreading risks. People who are prone to risks are willing to pay insurance premiums that are greater than the expected value of a certain risk so as to transfer that risk to the insurance.

Mitigating Moral Hazard

Another way to be efficient is to create insurance contracts that require that the loss be shared between the insured and the insurer. Insurance companies can share the loss with policyholders through copayments and deductibles.

Insurance companies can leverage the power they have to control some primary activities to induce safer behavior. Insurers can refuse to issue liability coverage to a person who does not take steps to ensure their safety and take care of their health. Another way is refusal to renew an existing policy to a person who is seen to be reckless.

The insurance company can also coach for safer conduct. They should educate the insured on ways of reducing and avoiding risks. They should provide programs for identifying and controlling risks. They should inspect and audit their clients, analyze their history of loss, how losses occur, identify causes of accidents and train them on how to avoid increases of premium.