

Moral Hazard

1. Objectives
2. Administrivia
3. Moral Hazard

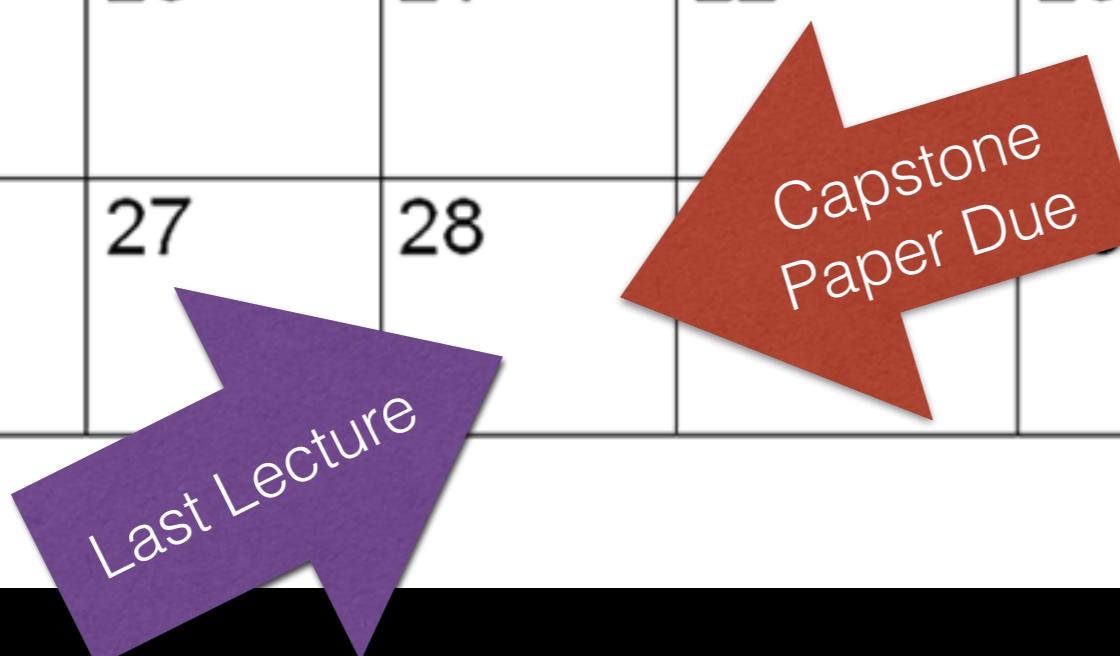
Objectives:

By the end of this lecture you should be able to:

1. State what moral hazard is
2. Identify moral hazard in different contexts
3. Sketch the general form moral hazard takes

July 2015

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
	29	30	1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28			31	



Anything Else? Anyone?

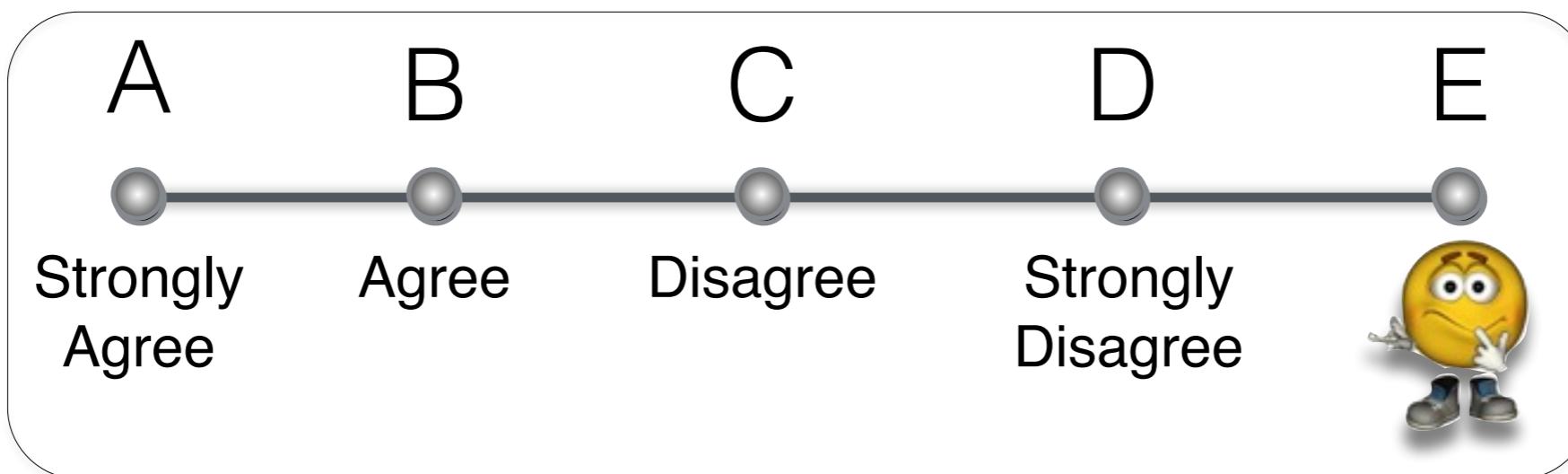




Poll

Claim

Group work is an opportunity to learn and grow as a person.





Poll

Question

When in a group, do you prefer getting a group mark, or a mark based on your specific contribution?

- A Group Mark
- B Individual Mark

Pillars of Morality



Reciprocity Empathy
Fairness Compassion

Empathy & Reciprocity

CBCnews | World

In repeated tests, rats freed another trapped rat in their cage, even when yummy chocolate served as a tempting distraction. Twenty-three of the 30 rats opened the trap by pushing in a door. The rats could have gobbled the chocolate before freeing their partners, but often didn't, choosing to help and share the goodies.

In some cases, the rats first took the chocolate chips out of a container, but didn't eat them, then freed the other rat and shared "almost as if they were serving them chocolate," Mason said. The **research is reported** in Thursday's journal Science.



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Poll

Question

Do you prefer working in groups or individually?

- A I prefer working in groups
- B I prefer working by myself



Luis Cabral

“

The optimal contract between shareholders and managers is ...one that balances the benefits from insuring the manager against risk, on the one hand, and the benefits from providing the manager with the right incentives, on the other hand.

- Luis Cabral, Industrial Organization, p. 35.

”

But there is a cost to group work

Question:
What does this
Dilbert comic...



Moral Hazard

...have in common with this article on helmets in lacrosse...

The screenshot shows the top navigation bar of The New York Times website, with links for HOME PAGE, TODAY'S PAPER, VIDEO, MOST POPULAR, and TIMES TOPICS. Below this is the main header "The New York Times" and the "Sports" section header. A navigation bar below "Sports" includes links for WORLD, U.S., N.Y. / REGION, BUSINESS, TECHNOLOGY, SCIENCE, HEALTH, SPORTS, and OPINION, along with specific sports links for BASEBALL, N.F.L., COLLEGE FOOTBALL, N.B.A., COLLEGE BASKETBALL, HOCKEY, and SOCCER. A green advertisement box contains the text "Dear mortgage, Can I take time off to play peekaboo?" and a "Learn about a payment vacation" button. The main article title "A Case Against Helmets in Lacrosse" is displayed above a photograph of two female lacrosse players in action. One player is wearing a helmet and the other is not. A caption below the photo reads: "Helmets, except for goalkeepers, are banned in women's lacrosse. 'This to me is like, come on, you're not serious.' Dr. Larry French".

...and this article about penalizing smokers and overeaters?

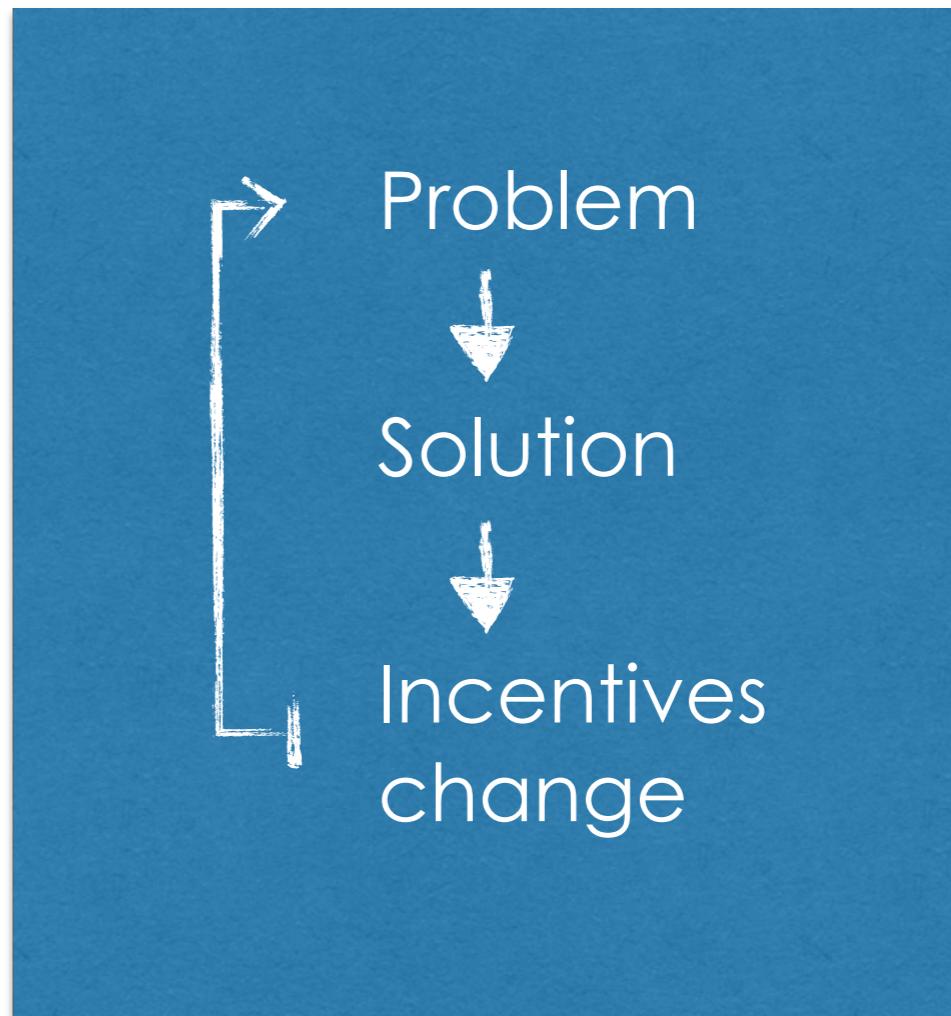
The screenshot shows the homepage of The Vancouver Sun. At the top left, there's a promotional banner for the 2013 budget, reading "ONLINE NOW BUDGET 2013 - TIGHTEN YOUR BELTS..." with a small photo of a man in a suit. The main title "THE VANCOUVER SUN" is prominently displayed in large, bold letters. Below the title is a navigation bar with links for NEWS, OPINION, BUSINESS, SPORTS, ENTERTAINMENT, LIFE, HEALTH, TECHNOLOGY, TRAVEL, and JOBS. A large, dark banner below the navigation bar features the text "TRY UNLIMITED DIGITAL ACCESS WEB • SMARTPHONE • TABLET" and a "99¢" offer for the first 30 days, along with a "SUBSCRIBE" button. The main article headline is "Analysis: Is it fair to penalize smokers and overeaters? Yes, say experts. Here's why." by Mike Stobbe, dated January 28, 2013. The article preview includes a small image of a person.



Well?

So...what is moral hazard?

- The solution shields the agent from the full consequences of their actions, thereby incentivizing more of the same problematic behaviour



Moral Hazard

Where does moral hazard arise in sports?

The screenshot shows the New York Times Sports homepage. At the top, there are navigation links: HOME PAGE, TODAY'S PAPER, VIDEO, MOST POPULAR, and TIMES TOPICS. Below that is the "Sports" section header. Underneath are links for WORLD, U.S., N.Y. / REGION, BUSINESS, TECHNOLOGY, SCIENCE, HEALTH, SPORTS, and OPINION, along with specific sports categories like BASEBALL, N.F.L., COLLEGE FOOTBALL, N.B.A., COLLEGE BASKETBALL, HOCKEY, and SOCCER. A green advertisement box contains the text "Dear mortgage, Can I take time off to play peekaboo?" and a link "Learn about a payment vacation". The main article headline is "A Case Against Helmets in Lacrosse", accompanied by a photograph of two female lacrosse players in action.



CBCnews | Health

Helmets, mouthguards could offer false sense of security

Guide aims to help doctors, sports teams better manage concussions

CBC News | Posted: Mar 12, 2013 2:08 PM ET | Last Updated: Mar 12, 2013 2:40 PM ET □ 44

"An important consideration in the use of protective equipment is the concept of risk compensation ... where the use of [this] equipment results in behavioural change, such as the adoption of more dangerous playing techniques, which can result in a paradoxical increase in injury rates," the authors wrote.

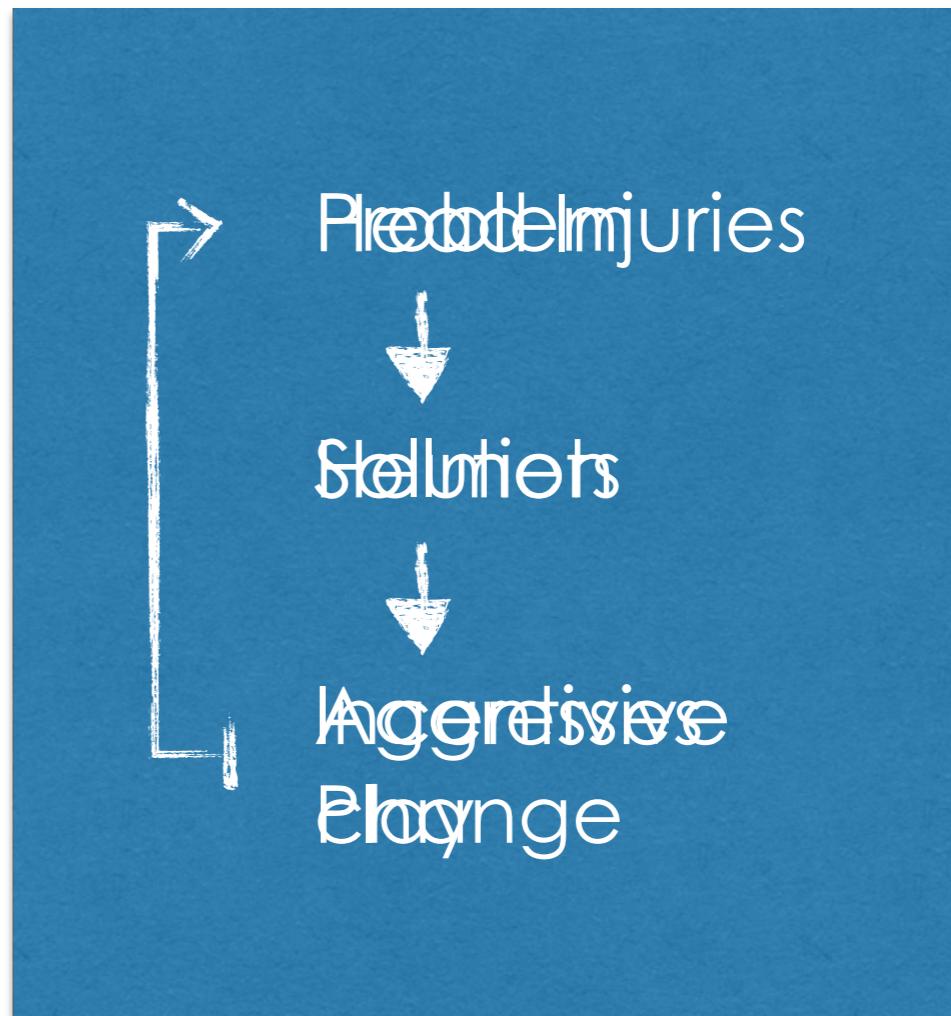
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Pittsburgh Penguins captain Sidney Crosby lets a puck slide off his helmet in January. The new concussion guidelines apply to athletes of all skill levels age 13 and older. (Gene Puskar/Associated Press)

So...what is moral hazard?

- The solution shields the agent from the full consequences of their actions, thereby incentivizing more of the same problematic behaviour

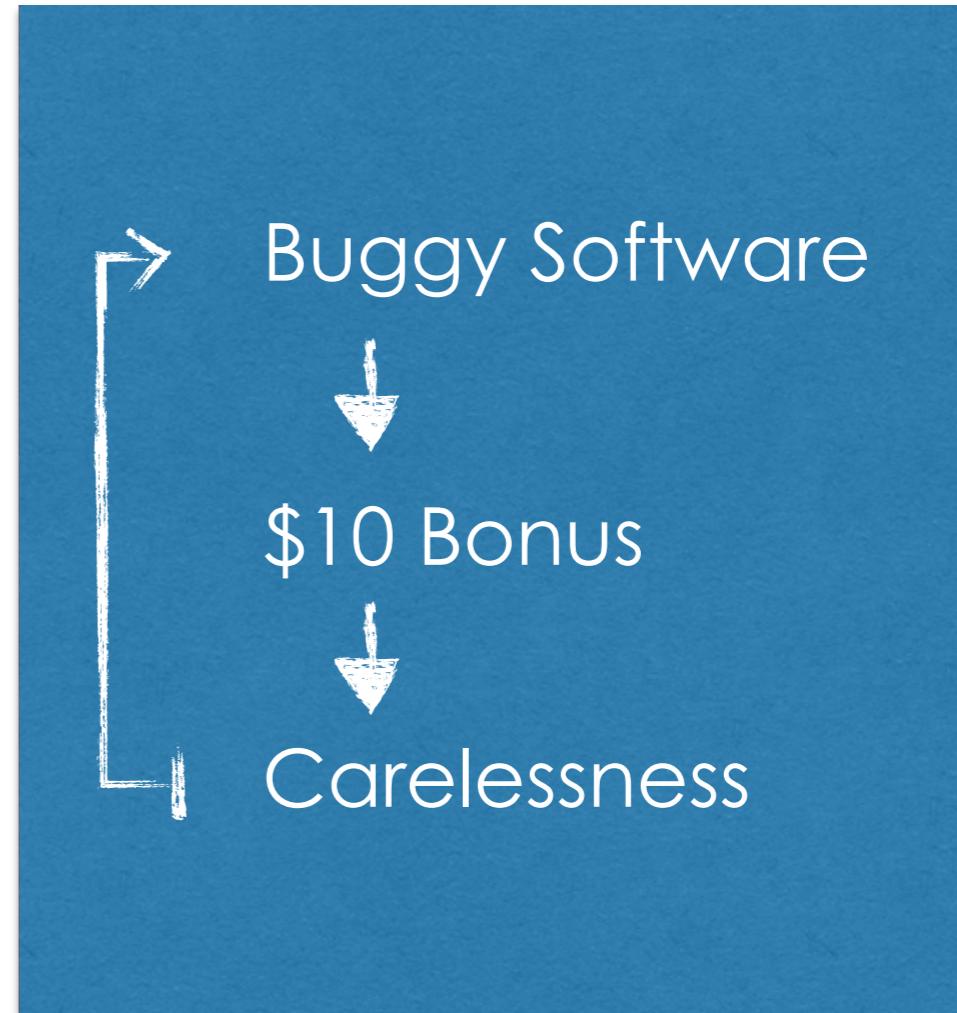


Where is moral hazard in this comic?



So...what is moral hazard?

- The solution shields the agent from the full consequences of their actions, thereby incentivizing more of the same problematic behaviour





1. It can occur any time we are shielded from the full consequences of our actions
2. It can trip us up quickly if we are not careful
3. It requires nuanced distinction making



Luis Cabral

“

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- Luis Cabral, Industrial Organization, p. 35.

”

How would people behave if they weren't insured?

How would their behaviour change once they bought insurance?



People's incentives
change because
they are off the
proverbial hook if
there is a fire

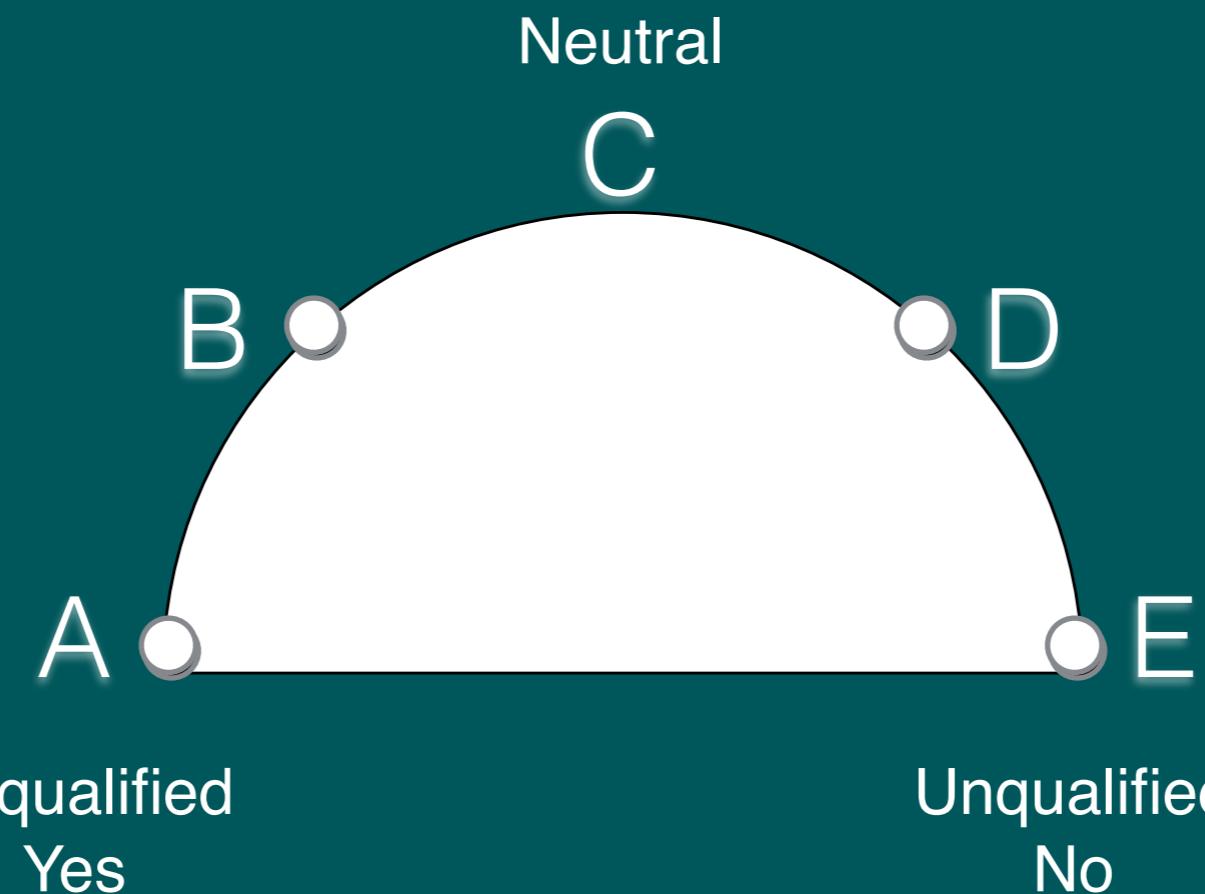




Poll

Question

Would the presence of moral hazard stop you from buying fire insurance?





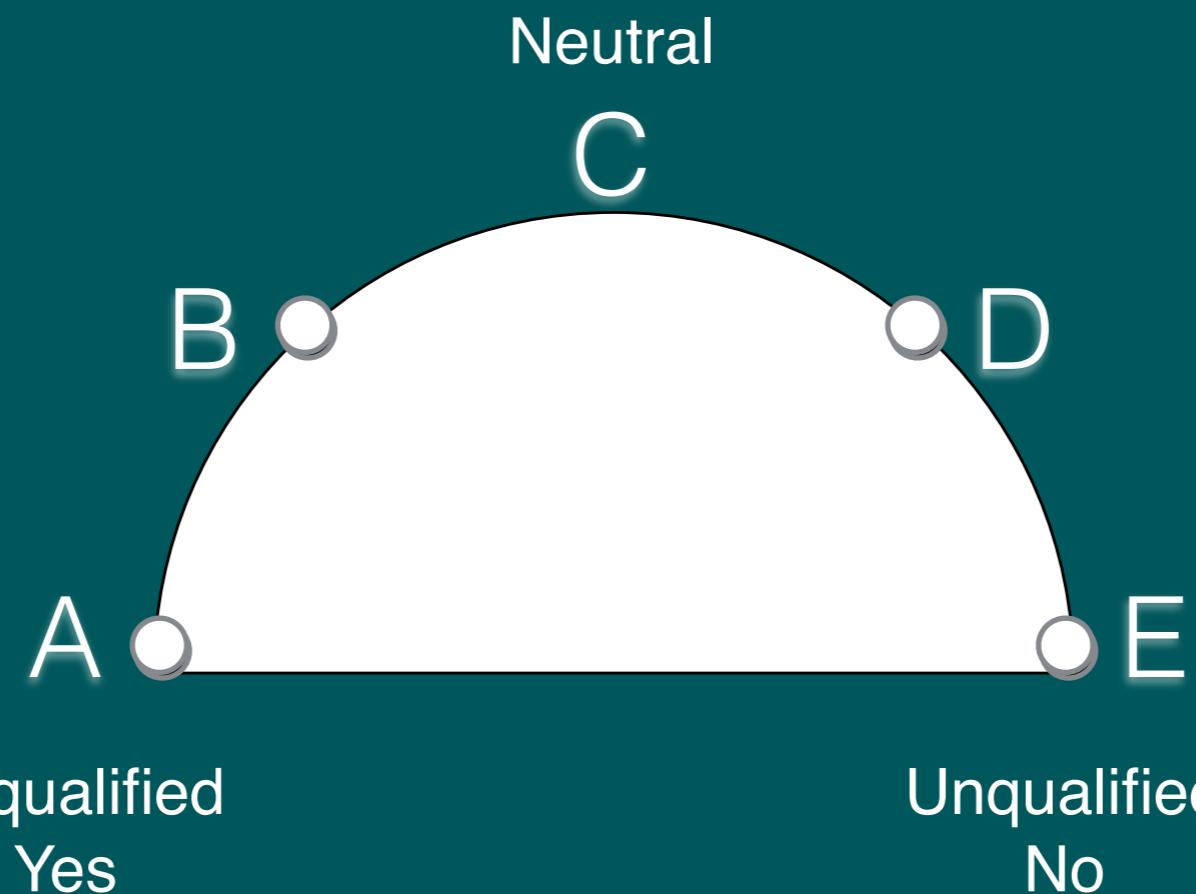
What other types
of insurance are
there?



Poll

Question

Should we have food programs in our schools for under privileged children?





“

Why? Because they breed. You're facilitating the problem if you give an animal or a person ample food supply. They will reproduce, especially ones that don't think too much further than that. And so what you've got to do is you've got to curtail that type of behavior. They don't know any better.

- S.C. Lt. Gov. Andre Bauer

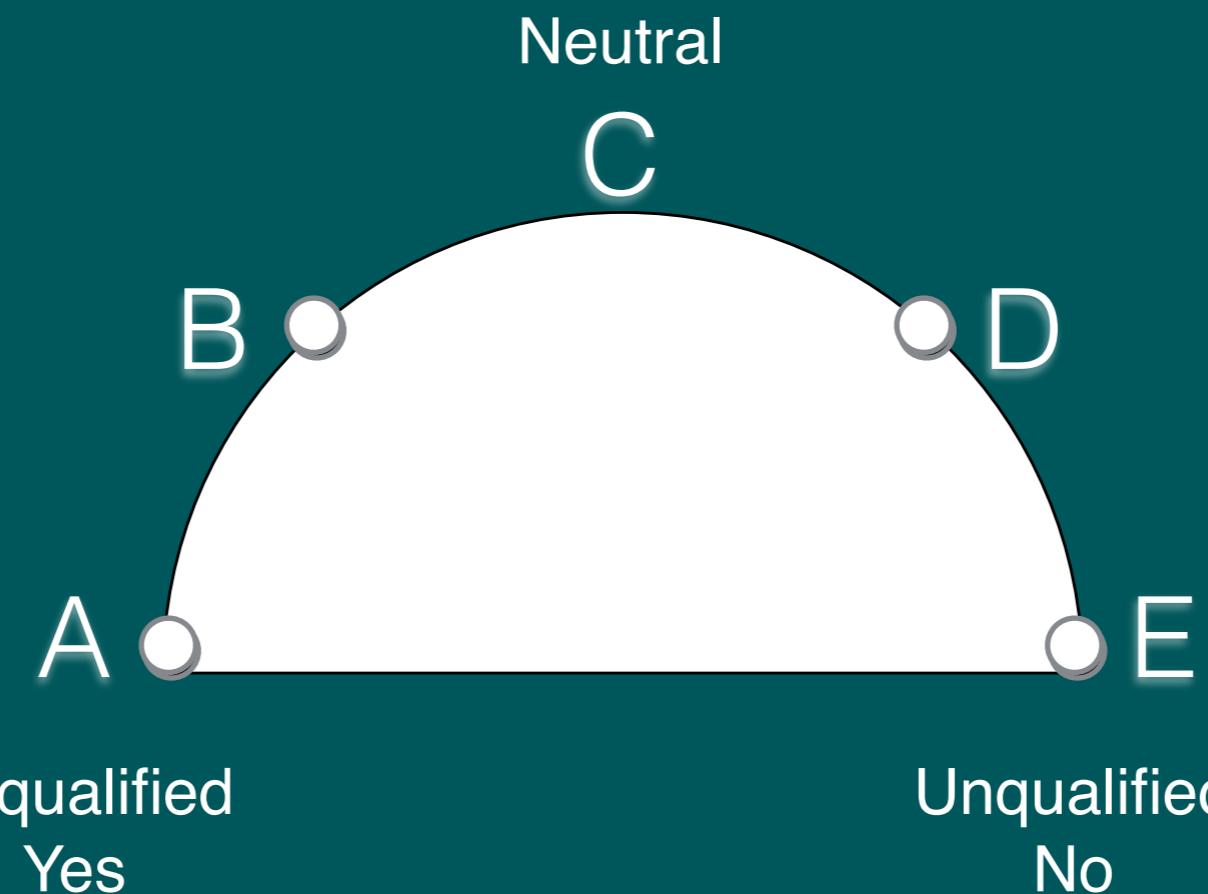
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Poll

Question

Should we scrap food programs in schools because of moral hazard?



What's the most you would do?

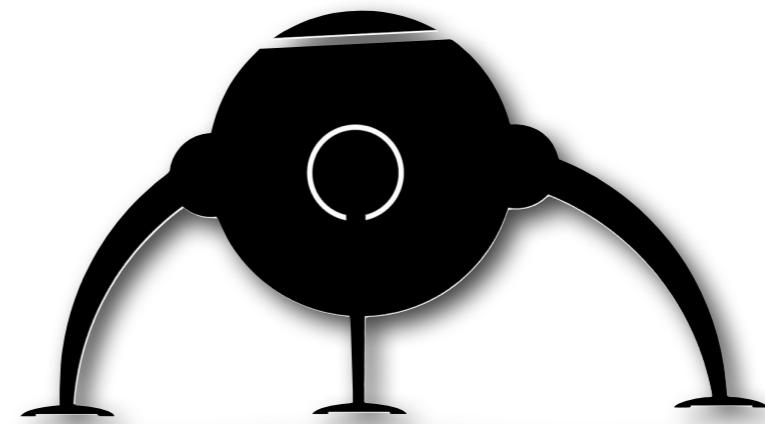


- (E) Swim out to the kid
- (D) Make a human chain
- (C) Throw something that floats
- (B) Dial 911
- (A) Do nothing

The screenshot shows the CBC News Edmonton website. At the top, there is a navigation bar with links for Home, World, Canada, Politics, Business, Health, Arts & Entertainment, Technology & Science, Community, and Video. Below this is a secondary navigation bar with links for Canada, Edmonton, News, Events, Weather, Programs, Video, and Audio. The main headline reads "Man and dog rescue 2 girls from icy Edmonton river". A sub-headline below it says "1st girl pulled to safety, then dog rescues man struggling to save 2nd girl". At the bottom of the page, there is a small note indicating the story was last updated on April 1, 2013, at 12:44 PM MT.



To save a drowning child, all you have to do is pay the parents \$2

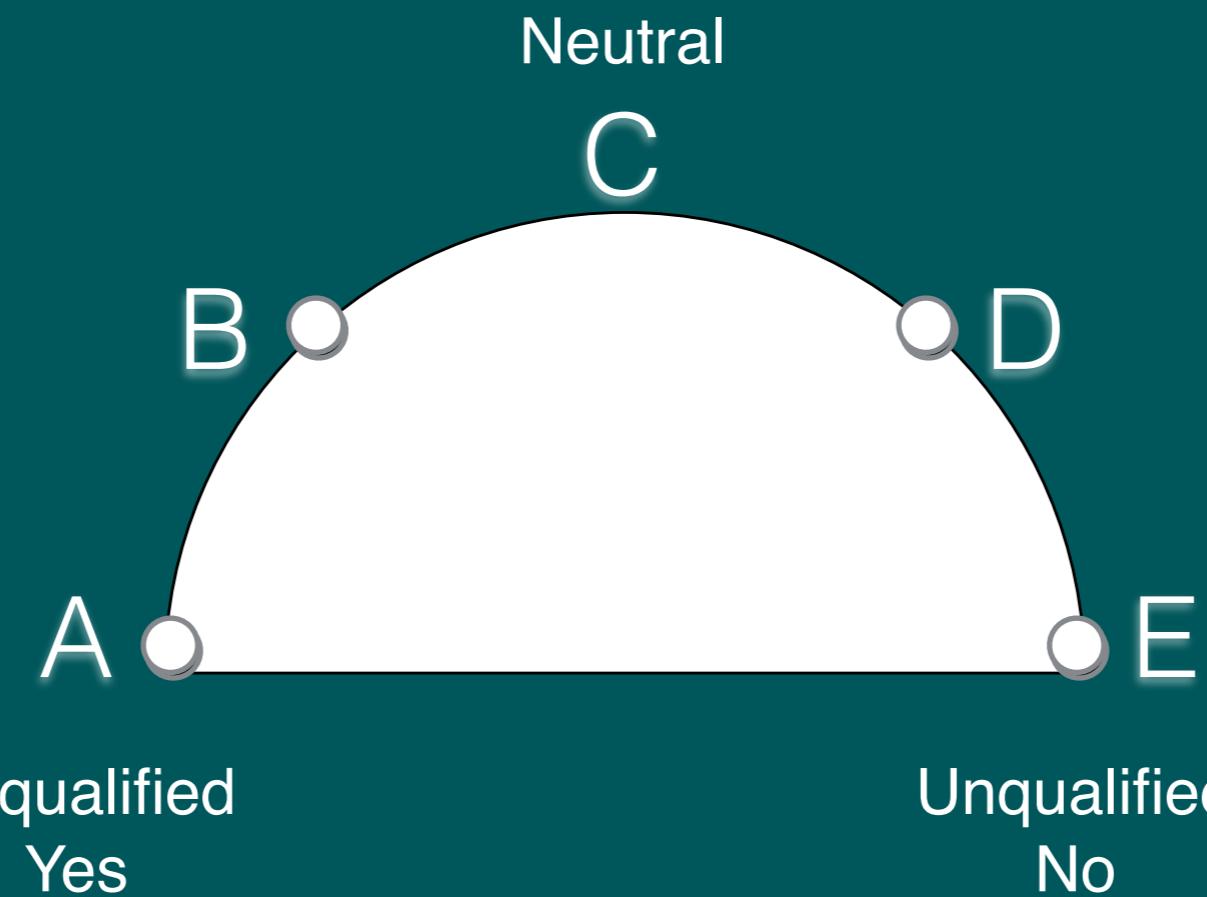




Poll

Question

Would you pay \$2 to save the life of a child?

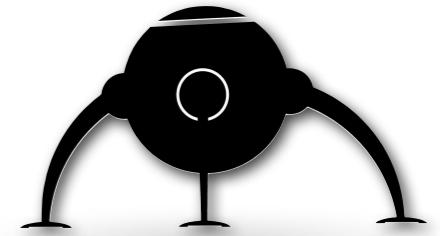






At what point would you stop paying?

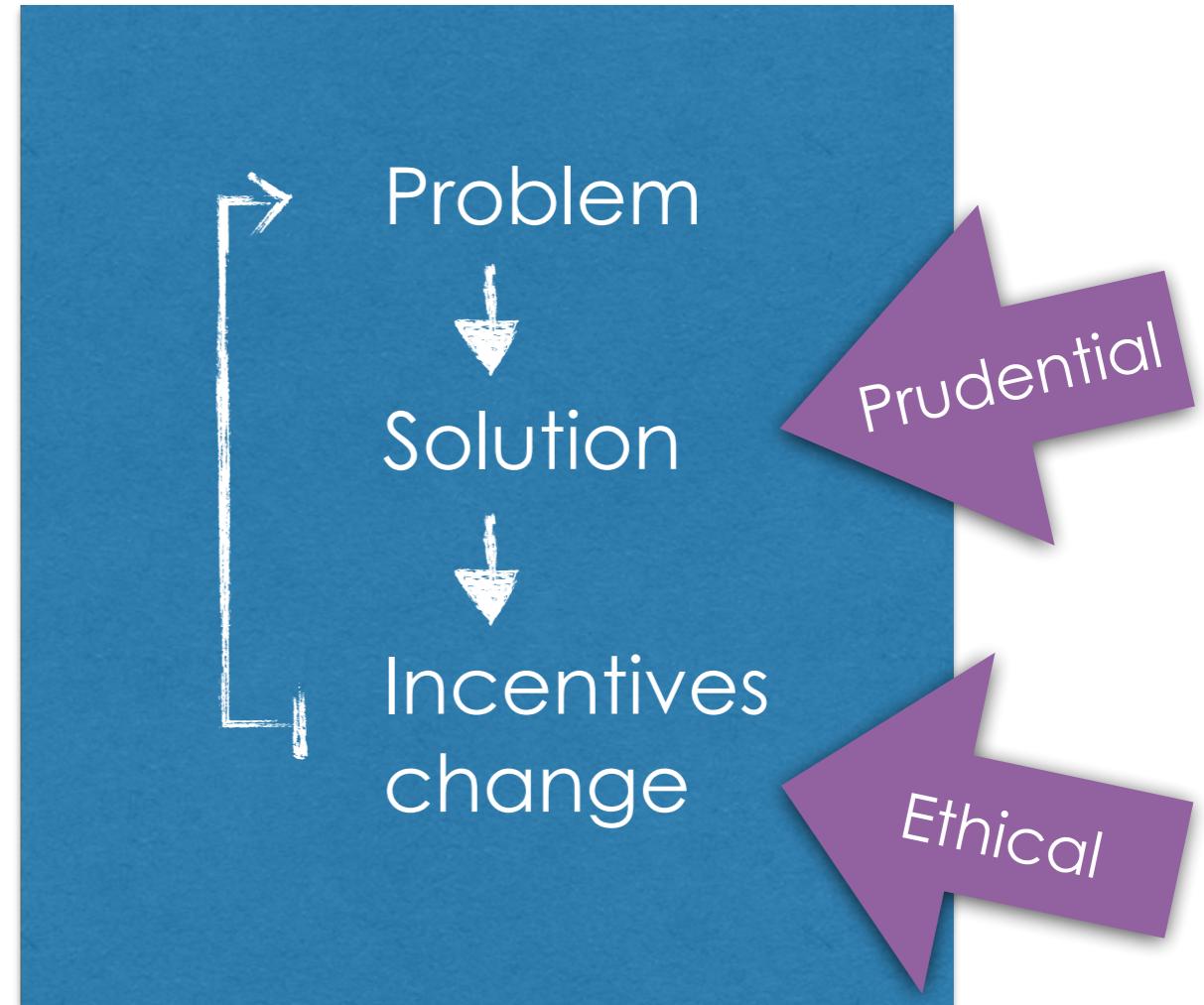
- (E) Until I am out of money
- (D) \$50
- (C) \$10
- (B) \$2
- (A) I would not pay again



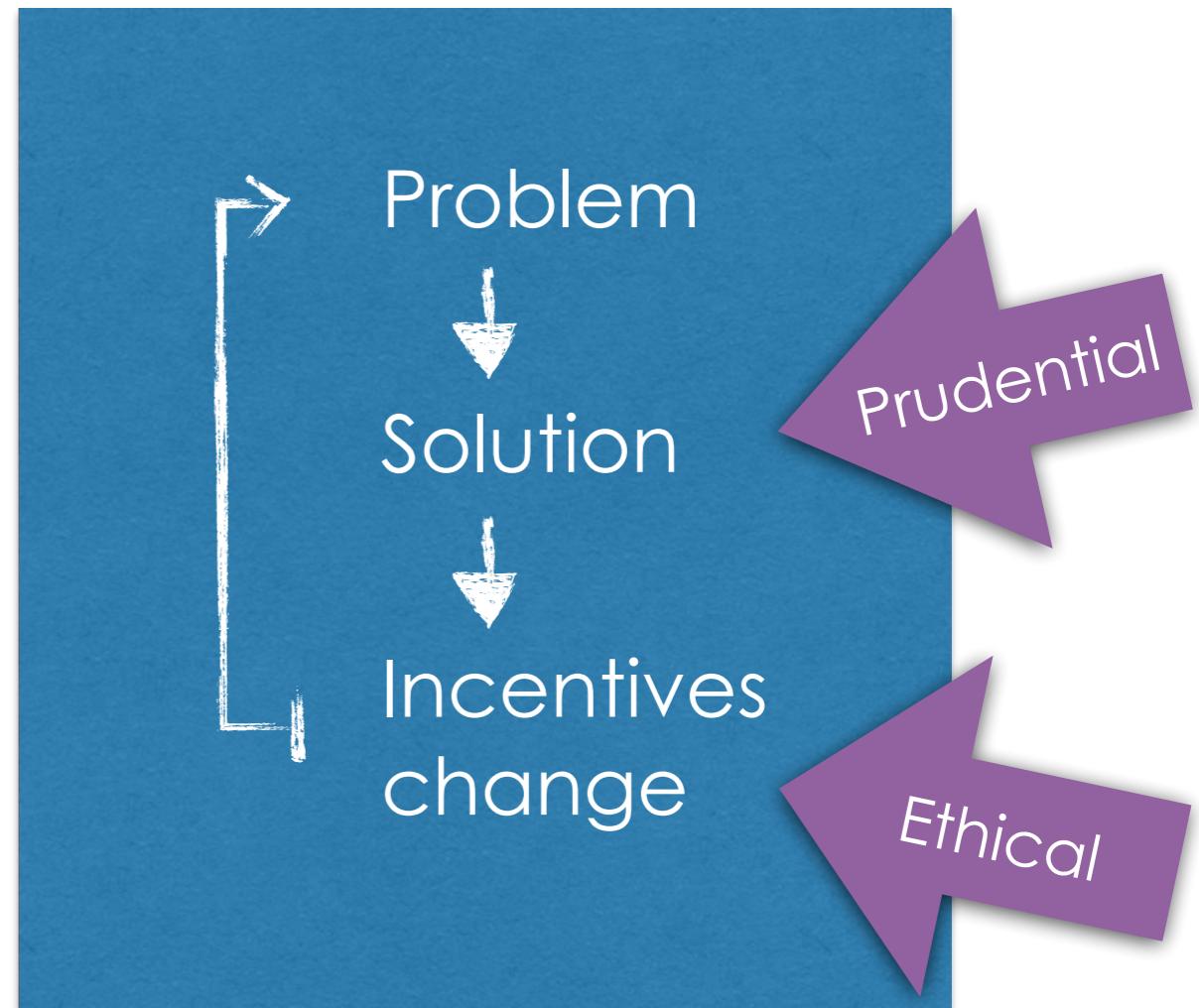


And that is how
easily moral hazard
can trip us up!

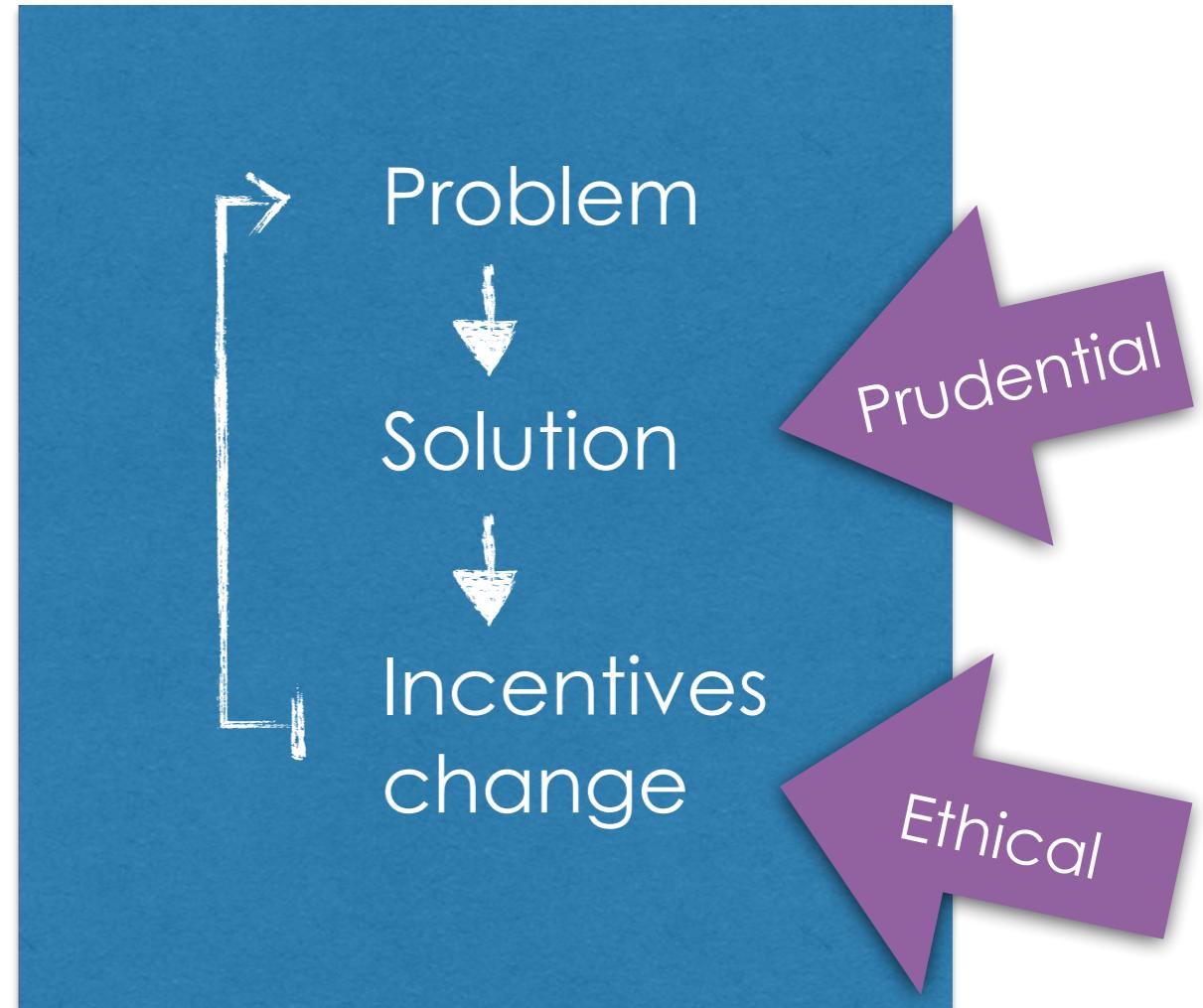
Thinking clearly about moral hazard requires us to distinguish between prudential reasons and ethical reasons



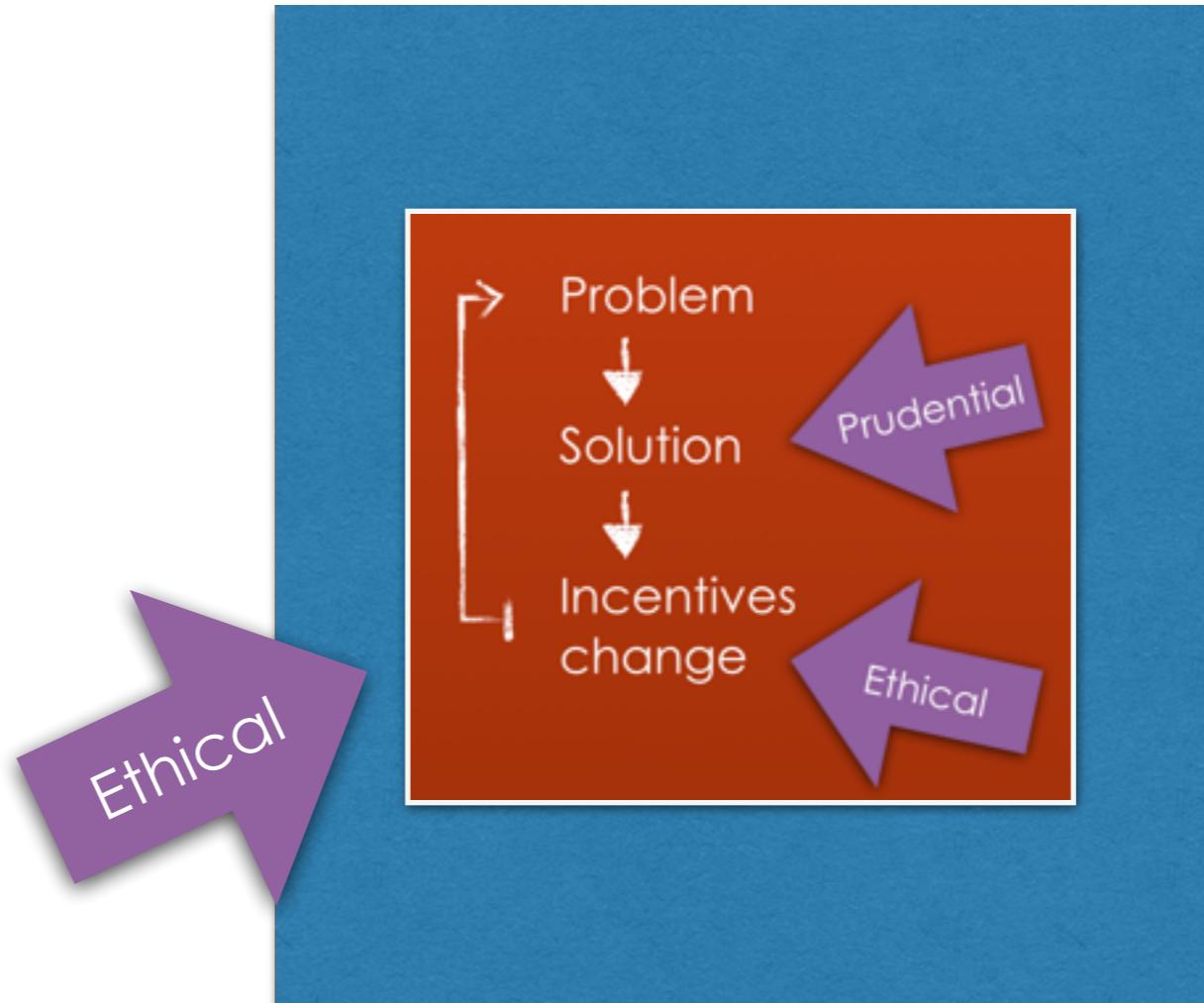
Coming up with a solution requires prudential reasoning. What will help us eliminate the problem?



How we respond to the change in incentives is often a matter of ethics



How we respond to people who has been tripped up by moral hazard is also a matter of ethics



Means:

Make it easier for people to access mortgages



Goal:

Homeownership for more middle-class families



Means:

So they turn around
and sell them to
investment banks

Banks won't want to
keep their money
tied up in mortgages



Means:

So they turn around
and sell mortgage
backed securities to
investors

Investment banks will
want to sell off this
debt to make money



- Banks were making NINJA loans: no income, no job or assets
- Investors were willing to take the bet. They were making a lot of money



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Moral Hazard

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Eurozone crisis

Alexis Tsipras battles own MPs over Greek bailout deal

Greek prime minister in talks with own MPs amid speculation he could be forced to form a national unity government and sideline leftwing Syriza faction

Phillip Inman in London, Helena Smith in Athens and Jennifer Rankin in Brussels

Tuesday 14 July 2015 12.40 BST

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Greek Prime Minister Alexis Tsipras speaks with the media after a meeting in Brussels on Monday. Photograph: Geert Vanden Wijngaert/AP

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