

Insurance – Adverse Selection

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Spring 2009

Adverse Selection

- ▶ Definition: Adverse selection is the tendency for people who need insurance (the unhealthy) to be more likely to have insurance, or to choose more generous insurance plans
- ▶ asymmetric information: one knows more than other; e.g. patient knows more than insurer

Lemons Principle

Lemons Principle: when there is asymmetric information, the bad drives out the good

Akerlof's (1970) used-car market

- ▶ When insurance companies can't determine your health, they assume average health and charge appropriate premium
- ▶ That premium will be too high for those in good health
- ▶ Only those in poor health will buy policies and insurance company will lose money, charge higher premium
- ▶ Higher premium will chase away the healthiest group again
- ▶ Unhealthy drives out the healthy – adverse selection into health insurance

Experiment

1. Divide into 3 seller groups; Read instructions
2. Sellers choose premiums for T1 policy and T2 (sicker) policy
3. Post premiums on board
4. I will choose 4 cards at random telling me the 4 types of buyers this round
5. I will act as the buyers and choose policies to buy, or choose not to buy
6. Rule: Each seller can only sell 2 policies total
7. Record results on sheet and on board
8. Repeat 3 more times

Asymmetric information period

'The state legislature has just enacted a community rating regulation, which requires insurance companies to set premiums at the same level for all buyers. Premiums set by sellers in this next period are subject to this new regulation, and no seller can refuse a sale at the posted premium in light of the buyer's type.'

1. Sellers choose one premium
2. Post premiums on board
3. I will choose 4 cards at random telling me the buyer types this round
4. Acting as buyers, I will choose policies to buy, or not
5. Record results on sheet and on board
6. Repeat 2 more times

Discussion

What happened to sellers' earnings over the first few periods of the game, and why?

Discussion

How were sellers affected by the community rating regulation, and did sellers adopt a specific strategy under this regime?

Discussion

How were the earnings of type 1 (low risk) and type 2 (high risk) buyers each affected by the community rating regulation?

Discussion

Can you think of practices that sellers could adopt to figure out which buyers are low risk and which are high risk?