Insurance

Two concepts important in insurance are *adverse selection* and *moral hazard*.

That people respond to incentives is the source of each problem.

Adverse Selection

Adverse selection is the phenomenon that bad risks are more likely than good risks to buy insurance.

Adverse selection is seen as very important for life insurance and health insurance.

Moral Hazard

Moral hazard is the phenomenon that having insurance may change one's behavior. If one is insured, then one might become reckless.

Moral hazard is seen as somewhat important for property insurance.

Before and After

Adverse selection occurs before the insurance is purchased, whereas moral hazard occurs afterwards.

Cause of Adverse Selection

Traditionally, differential information underpins adverse selection. The insurer cannot identify the good and bad risks, even though the insured have some idea whether they are bad or good risks. The insurer attempts to gain additional information, such as by requiring a medical exam for life insurance.

More recently, government intervention in insurance markets results in adverse selection. The insurer knows who are the bad risks, but the government forces them to insure these bad risks, without any extra premium.

Effect of Adverse Selection

For either possibility, the danger is that the bad risks will buy insurance and the good risks will not.

Individual Health Insurance

An example of this outcome is individual health insurance in New York State. For the past two decades, the state has required insurers to offer health insurance to all, regardless of any prior condition in the health of the insured ("guaranteed issue"). The sick have bought insurance and the insurance premiums have soared, causing the healthy to stop buying the insurance. Consequently the premiums have risen yet higher, as so many of the insured are sick.

Effectively there is no longer individual health insurance: the sick are paying for the (high) cost of their care, and the healthy are uninsured.

Subsidized Flood Insurance

Another example of adverse selection and moral hazard is federal flood insurance. For the past fifty years, the federal government has offered heavily subsidized flood insurance to homeowners. As a result, a continuous line of wall-to-wall beach houses now front on the ocean beaches of America. If waves from a storm wreck the house, the insurance pays for rebuilding.

The value of the subsidy is substantial, worth a present value of hundreds of thousands of dollars per property. Without the subsidized insurance, the beach houses would never have been built. Before subsidized insurance became available, beach houses were far less numerous. Those built were typically low cost and flimsy, because the owners feared damage, and insurance was expensive.

Most inland houses are in no danger of flooding, and their owners do not buy flood insurance.

Differential Information

Both adverse selection and moral hazard may revolve around differential information.

For adverse selection, the insured may know things that the insurer does not know.

Moral hazard would not be a problem if the insurance would cover only claims for which the insured is not responsible. However the insurer lacks the information to prove this finding. Furthermore, in many cases, the insurer must pay a claim even though it is clear that the insured did behave recklessly.

Asymmetric Information?

The economics literature uses the phrase “asymmetric information” when discussing adverse selection and moral hazard, but this usage seems faulty. What matters is that different people have different information; whether this differential information is “asymmetric” or “symmetric” seems irrelevant.

The word “asymmetric” is a fad word, in that asymmetric games are of great current research interest in game theory.

Bank Loans

Some economists argue that adverse selection and moral hazard are significant factors for bank loans. The bank fears that loan applicants will tend to be those who perhaps will not repay and that a loan recipient may use the funds borrowed to spend more and thus to reduce the likelihood of repayment. Banks do devote considerable resources to the evaluation of loan applicants and the policing of borrowers to ensure repayment.

Collateral

The traditional way to ensure repayment is to require collateral. Mortgage loans and car loans are secured by collateral, so the loan interest rate is low. Personal loans and credit card loans are not secured by collateral, so the loan interest rate is high, and usually the amount borrowed is small. Consequently adverse selection and moral hazard are perhaps important for personal and credit card loans.