

## INSURANCE LAW

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The text for this class is Kenneth S. Abraham and Daniel Schwarcz's **Insurance Law and Regulation** (7th Edition, 2020). Unlike some first-year texts, the writing between cases is not fluff; it is central to learning and exploring the subject matter. Most of the sections have problems and questions that you will answer for yourself before coming to class. I recommend writing down your analysis. Some answers will be a phrase or a line but others will be more detailed.

For the first class:

1. Read Chapter One. Do not be deceived by its relatively short length. The concepts are fairly dense and there are three cases you will want to contemplate before we meet.

2. After reading the sections on risk allocation and adverse selection, attempt to answer the questions on the next page. You will not be handing your answers in to me; we will discuss as a group.

### Questions on risk allocation and adverse selection

(1) Suppose Alpha Insurer has 1000 policyholders and those policyholders all have a 10 percent chance of being involved in a car accident. Each accident costs the insurer \$10,000. If Alpha charges every policyholder the same rate, what premium will it charge policyholders next year if it wants to offer an actuarially fair policy (i.e., a policy in which the premium equals the expected value of the policy)?

Just to get the ball rolling: The expected cost of each policyholder to the insurer is the cost of the risk (10,000) \* the chance of the risk occurring (10%) = \$1,000.

(For now, we are ignoring the expense of running the company and the time value of the money the insurance company can invest during the course of the policy.)

(2) Now suppose that unbeknownst to the insurer, half of its policyholders are “peaches” and half are “lemons.” Peaches know that they only have a 5 percent chance of being in an accident, whereas lemons are aware that they have a 15 percent chance of being in an accident. How will peaches and lemons evaluate Alpha’s offer of insurance from Question 1?

(3) Suppose that 200 peaches choose not to purchase insurance rather than pay the premiums calculated in question 1. What premium will Alpha now have to charge if it again does not attempt to allocate risks and it wants to offer the same actuarially fair policy to everyone?

Don’t be concerned if this throws you. We will discuss it.

(4) How will peaches and lemons now evaluate the insurer’s offer of insurance from question 3?

(5) How would it impact the above analysis if Beta Insurer could distinguish between peaches and lemons and offered all peaches coverage for \$510?