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AN EMPIRICAL STUDY

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Asymmetric Learning in Repeated Contracting: An Empirical Study

Alma Cohen*

Abstract

This paper studies a unique panel dataset of transactions with repeat customers of an insurer operating in a market in which insurers are not required by law or contract to share information about their customers' records. I use this dataset to test the asymmetric learning hypothesis that sellers obtain over time private information that some of their repeat customers have low risk, and that this learning enables sellers to make higher profits in transactions with these repeat customers. Consistent with this hypothesis, I find that the insurer in my dataset makes higher profits in transactions with repeat customers and that these profits are driven by transactions with repeat customers with good past claims history with the insurer; that these higher profits result from repeat customers with good claim history receiving a reduction in premiums that is lower than the reduction in expected costs associated with such customers; and that policyholders with bad claim history are more likely to flee their record by switching to other insurers.

JEL Classifications: JEL classification: D40, D80, D82, D83, L10, G22.

Keywords: Repeat customers, asymmetric information, asymmetric learning, adverse selection, insurance, market power.

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1. Introduction

Ever since the seminal work of Akerlof (1970) and Rothschild and Stiglitz (1976), economic theorists have paid much attention to the operation of markets characterized by informational asymmetries. One type of informational asymmetry that has received substantial attention from economic theorists arises from asymmetric learning accompanying repeated contracting between two parties. In such a case, a seller (buyer) might learn about a repeat buyer (seller) information that other potential sellers (buyers) do not have. When such asymmetric learning occurs, parties may ex post obtain market power and thus make higher profits from repeated contracting. This paper uses a unique panel data to investigate asymmetric learning in repeated contracting.

Theoretical multi-period models focusing on asymmetric learning in repeated contracting have been developed for a wide range of markets. For example, in a series of influential articles in labor economics, researchers developed models in which current employers are better informed about the ability of their employees than future potential employers (see e.g., Waldman (1984), Greenwald (1986), Milgrom and Oster (1987), Ricart i Costa (1988), and Laing (1994)). In these models, the stream of job switchers is disproportionately composed of less able workers, wages to switchers are set accordingly, and current employers have some market power over workers who are known to them (but not to other potential employers) to be of high quality.

Another line of asymmetric learning models focuses on credit market (see, e.g., Sharpe (1990), Rajan (1992), Dell'Ariccia, Friedman, and Marquez (1999), Marquez (2002), and von-Thadden (2004)). In these models, banks over time acquire information about repeat borrowers that other banks do not have. This learning enables banks to

obtain market power with respect to borrowers whose high quality is known to the bank but not by rival banks. Similarly, asymmetric learning models have been developed for insurance markets (see, e.g., Kunreuther and Pauly (1985), Prendergast (1992), Nilssen (2000), and de Garidel-Thoron (2005)). In these models, the realization of policy risks enables insurers to learn over time information about their repeat customers that competing insurers do not have. This learning about repeat customers enables insurers to gain an information-based competitive advantage over rival insurers.

While the theoretical literature on asymmetric learning is large, substantial empirical testing of asymmetric learning did not develop in parallel. Empirical work on markets with informational asymmetries has focused on adverse selection resulting from informational asymmetries between buyers and sellers,¹ and relatively little work has been done on asymmetric learning in the presence of repeated contracting. The limited testing of asymmetric learning models has been at least partly due to the unavailability of data that would enable researchers to observe prices, profits, costs, and perceived quality in repeated contracting situations. For example, to test directly the hypothesized existence of asymmetric learning in labor markets – that is, to test whether an employer is able to make higher profits on current employees whose high quality is known to the employer but not to other potential employers – an econometrician would need to observe all the information that the employer obtains about any given employees as well as the profit that the employer makes on the given employees.

¹ See, e.g., Gensove (1993), Puelz and Snow (1994), Cohen (2003), and Finkelstein and Poterba (2004). For surveys of empirical work in this area, see Chiappori (2000) and Cohen and Siegelman (2007).

Given the demanding data requirements for direct testing, some empirical work has used creative indirect tests. In an influential article that provides evidence of learning from repeated contracting in the labor market, Gibbons and Katz (1991) take advantage of information about the reasons for employees' departure. The study uses the fact that some employees lose their job due to plant closings – exogenous shocks that are unrelated to employer learning about employee quality, and thus do not lead new employers to draw a negative inference from the employees having been laid off. It finds that workers who are hired after being laid off by another employer receive higher wages when they were laid off due to plant closing than when they were laid off by a firm that had discretion whom to lay off.² In addition, empirical work on the subject has shown that having a long-term relationship with a bank has a positive effect on the availability of credit (Petersen and Rajan (1994)).

In the insurance market, D'Arcy and Doherty (1990) show that, consistent with asymmetric learning, insurers contractually bind their agents from selling private information about customer records to rival insurers and that entry into the insurance market is costly. They also document that the profits for cohorts of policyholders decline with company experience. The compared cohorts of policyholders could well have differed in aspects other than the policyholder's experience with the company, and the authors did not have the data necessary for controlling for differences in policyholder characteristics other than company experience.³

² Doiron (1995) and Grund (1998) apply the approach of Gibbons and Katz (1991) to labor market data from Canada and Germany respectively.

³ Insurance markets have also been the subject of empirical work investigating types of learning other than the asymmetric learning on which I focus in this paper. Studying long-term insurance markets, Hendel and Lizarri (2003) provide evidence that their structure is influenced by expectations that, over time, there will be symmetric learning in which all market participants

This paper uses a unique panel dataset of repeated contracting in the insurance market to investigate sellers' learning about their repeat customers and their resulting ability to make profits on customers they identify as being of high quality. The dataset has several features that make it especially well-fitting for studying the subject. To begin, the dataset includes all the information that the insurer has about each policyholder, including information relevant to assessing the policyholder's "quality" (risk). The dataset also includes full information about the realization of risk of each policy, and thus enables the researcher to observe the profit made by the insurer on each repeat customer and its relation to what the insurer knows about the customer. In addition, the dataset contains information about each policyholder's decision whether to stay with the insurer after the policy period. Finally, a notable feature of the Israeli insurance market is the lack of systems, which could prevent asymmetric learning, for sharing information among insurers.

My analysis yields several findings that are consistent with asymmetric learning. To begin, I find that the insurer makes higher profits on repeat customers and, more importantly, that these higher profits are driven by profits made on customers with good records with the insurer. Furthermore, the longer the period over which the customer has a good record, the higher the profits made by the insurer. Under the asymmetric learning model, a good claim record with the insurer, and not merely experience with the insurer, is necessary for the seller's ability to make higher profits. The insurer does not have any information-based market power with respect to repeat customers with poor records. If

learn the realization of uncertainty concerning a policyholder's health. In addition, Crawford and Shum (2005) and Israel (2005a, 2005b) study learning by customers, who are generally price-takers in insurance markets, about the service quality of their insurer.

such customers were to switch to a rival insurer, the rival would not view their quality less favorably than the current insurer. In contrast, if a repeat customer with a good claim record with the insurer were to switch to a rival, the rival might be uncertain about the customer's quality. This state of affairs provides the insurer with some information-based market power over such customers.

Second, consistent with the asymmetric learning model, I find that a seller's higher profits on repeat customers with good claim records are due to their not receiving from the insurer a reduction in premium that fully reflects the customers' lower risk. While these repeat customers with good records are charged lower premia by the insurer, the reduction in premium is lower in magnitude than the reduction in costs (insurance payments) associated with such repeat customers. This pattern is stronger when the insurer has more private information about the repeat customers' low risk – that is, when the period over which the customers did not have claims with the insurer is long.

Finally, consistent with asymmetric learning and the insurer's possession of private information about repeat customers' risk type, I find that customers with poor claim records tend to leave the insurer, and customers with good records tend to stay for another period. Customers with a bad claim history have an incentive to flee their record and pool themselves with customers leaving their insurer because of exogenous shocks.

The results of the paper highlight the practical significance whether systems of sharing of information among insurers exist. As stressed earlier, the Israeli market for which I have data lacks any such system. The desirability of information-pooling systems has been much debated in Europe, where the European Commission ruled that some systems of information sharing were anticompetitive (de Garidel (2005)). In the U.S.,

some information about occurring accidents is maintained in state records, and it has long been observed (see, e.g., D'Arcy and Doherty (1990)) that the publicly available information is highly incomplete and that a new insurer would not be able to get from it the complete claim history of other insurers' customers. By showing that asymmetric learning does in fact arise in the absence of information pooling among insurers, the analysis suggests that pooling systems can have a practically significant effect. It would be worthwhile for future work to complement the findings of this paper by conducting a similar study in a market with complete or partial pooling of information among insurers.⁴

The remainder of the analysis is organized as follows. Section 2 provides a theoretical framework and describes the hypotheses that will be tested. Section 3 describes the data and provides summary statistics. Section 4 presents my empirical analysis of the data. Section 5 concludes.

2 Theoretical Framework

In developing theoretical predictions for testing, it is important to note some important institutional features of the Israeli automobile insurance market in which the insurer whose data I study operates. As in many other insurance markets, the Israeli

⁴ That information sharing systems are practically important does not, of course, imply that their effect is positive or negative. Challenging prior work suggesting that asymmetric learning is welfare-reducing (Crocker and Snow (1986)), de Garidel (2005) recently developed a theoretical model showing that asymmetric learning could have welfare-increasing effects. The evidence in the current paper does not resolve the debate whether asymmetric learning and lack of information pooling systems are welfare-increasing or decreasing, but rather shows that the debate is of practical significance.

automobile insurance market is characterized by lack of legally mandated or privately developed arrangements for sharing information among insurers.⁵ Also, as is the case in other markets, the events for which claims are submitted often do not appear in public records, and new insurers thus cannot learn much about new customers just from inspecting public records (Insurance Research Council (1991)). Although policyholders switching to a new insurer are asked to indicate their past claim history on the forms they fill, policyholders might fail to report their true past claim history when they self-report, and it is generally believed in the industry that there is significant under-reporting by new customers.

Another noteworthy feature of the Israeli insurance market is that, as is the case in many insurance markets, insurers use only one-period policies. Furthermore, these one-period policies involve no commitments for subsequent periods on the part of either the customer or the insurer (Kunreuther and Pauly (1985)).⁶

To develop predictions concerning transactions with repeat customers in this market, let us consider a two-period model of repeated contracting in an insurance market. (The analysis can easily be extended to more than two periods.) The simple model discussed below is largely based on adapting to the insurance setting the classic models of Greenwald (1986), which models employers' learning over time about their employees,

⁵ Systems of information pooling existed in Belgium and France and were ruled to be anticompetitive by the European Commission. See de Garidel-Thoron (2005) for a welfare analysis of the desirability of such systems.

⁶ There is a line of work that models the optimal design of policies that commit customers and insurers to a multi-period contract (e.g., Dionne and Lasserre (1985), Cooper and Hayes (1987)) or that involve a one-sided commitment of the insurer to offer the policyholder certain terms in subsequent periods (Dionne and Doherty (1994), de Garidel-Thoron (2005)). Although such policies are observed in certain countries (see, e.g., Dionne and Vanasse (1992)), they are not used in the automobile insurance market in Israel.

and Sharpe (1990), which models banks' scholarship over time about their repeat borrowers.

Consider the following timeline. Suppose that, at $T=1$, a large number of risk-averse individuals enter the insurance market. At this time, all individuals appear identical to all insurers. Each individual chooses an insurer and purchases from the insurer a one-period policy against a certain type of loss during Period 1. After the realization of the Period 1 risk, each individual purchases at $T=2$ another one-period policy purchasing coverage for the second period against this type of loss; at this time the individual must choose whether to purchase a policy for Period 2 from the individual's first-period insurer or from a new insurer.

At $T=1$, when individuals first enter the market, insurers know that each policyholder belongs to one of two types $t=(L,H)$ whose probabilities of a loss in any given period are p_L and p_H respectively, with $0 < p_L < p_H < 1$. The loss in the event of an accident is L for both types. The fraction of H types in the population is α .

All insurers are assumed to be risk-neutral and to maximize the present value of their expected profits over the two periods; without loss of generality, we will assume that the discount factor is 1. The only contracts that insurers offer are single-period policies with a given deductible $d > 0$. Under these policies, in the event of a loss, the insurer would pay the policyholder an amount of $C = L - R$. Given that firms offer only one type of insurance coverage, and individuals thus will not be able to use private information to sort themselves among alternative levels of coverage offered, it does not matter for our purposes what information individuals entering the market have about their risk type.

During the first period, both the policyholder and the first period insurer observe the policy's realization of risks in the first period (Kunreuther and Pauly (1985), Watt and Vazquez (1997)). This learning enables the first-period insurer to update its prior belief about the likelihood that the policyholder is of type H . The realization of risks during the first period is not observable by other insurers to which the individual might elect to switch in Period 2, and insurers are not required by law or contract to share information. The assumption that other insurers cannot observe the experience of a new customer with the customer's prior insurer is similar to the assumptions made in the literature that new employers cannot observe the quality of work done under prior employers or that new banks cannot observe the information obtained by prior banks.

At the end of the first period, when policyholders switch to a new insurer and are asked about their past claim history, they might choose to misreport. Specifically, for any given individual, there is a positive probability $0 < h < 1$ that the individual will be willing, in the event that the individual switches and had an accident in the first period, to "hide" the accident and not report it. This assumption is consistent with the working premise of insurance professionals that self-reporting is often substantially incomplete or inaccurate (Insurance Research Council (1991)).⁷ Given that the first-period information is assumed to be unobservable by a new insurer, reporting of past claims might arise only due to internal norms and ethics, and it is assumed that this will happen with probability

⁷ One might wonder why new insurers do not ask new customers for statements from their prior insurer verifying their self-reports about past claim history. Alternatively, new customers with a good record might voluntarily elect to submit such statements. In the Israeli insurance market, however, insurers do not seek or use such statements.

$(1-h)$.⁸ The fact that self-reporting individuals might under-report past claims is taken into account by new insurers.

In the beginning of Period 2, each individual might experience with probability $0 < s < 1$ a random shock that will lead the individual to leave the current insurer. Thus, similar to Greenwald (1986), we assume that individuals might with some probability wish to change their contracting partner for reasons that have nothing to do with contract price. The fact that some policyholders switch for “random” reasons – such as, say, a change in workplace or location – is what makes it impossible for new insurers to infer that switching necessarily reflects a poor past record. Consistent with this assumption, my dataset shows that some individuals with an excellent record do switch. If the individual does not experience a shock, it is assumed that the individual will switch if and only if the price offered by a rival insurer is lower than the price offered by the current insurer.

In the first period, the probability of an accident that an insurer attaches to any new policyholder is: $\bar{p} = \alpha p_H + (1-\alpha) p_L$. The expected cost of a first-period policy to the insurer, in turn, is: $C^1 = \bar{p}(L-d)$.

At the end of the first period, the first-period insurer will use Bayesian updating based on the first-period realization of risks to revise its estimate of the policyholder’s type. Let us denote by α_A the probability of the policyholder being of type H conditional on the policyholder having an accident in the first period, and by α_{NA} the probability that a policyholder is of type H given that the policyholder did not have a first-period accident. Bayesian updating provides:

⁸ Cohen (2005), which focuses on new customers, finds evidence of substantial under-reporting by new customers.

$$\alpha_A = \frac{\alpha p_H}{\alpha p_H + (1 - \alpha) p_L}$$

$$\alpha_{NA} = \frac{\alpha(1 - p_H)}{\alpha(1 - p_H) + (1 - \alpha)(1 - p_L)}$$

Given this updating, the expected second-period cost that the first-period insurer will ascribe to the policyholder conditional on an accident in Period 1 is thus:

$$C_A^2 = (\alpha_A p_H + (1 - \alpha_A) p_L)(L - d)$$

And the expected second-period cost conditional on no accidents in the first period will be:

$$C_{NA}^2 = (\alpha_{NA} p_H + (1 - \alpha_{NA}) p_L)(L - d)$$

In this setup, it can be shown that the unique equilibrium has the following characteristics. To begin, individuals will switch if and only if they had a “switching” shock or had an accident and are prepared not to report it to the new insurer. The reason is that policyholders not subject to such a shock will be able to gain from such a switch if and only if they had an accident and are prepared not to report it. (If they were to switch and report an accident, the new insurer will charge them the same price as their current insurer, and thus they will not gain from the switch.)

In the unique equilibrium, new insurers will charge switchers who self-report to them no past accidents a price of: C_{S-RNA}^2 , $C_{NA}^2 < C_{S-RNA}^2 < C_A^2$, that is defined by:

$$C_{S-RNA}^2 = \frac{\bar{p}(s + (1 - s)h)}{\bar{p}(s + (1 - s)h) + (1 - \bar{p})s} C_A^2 + \frac{(1 - \bar{p})s}{\bar{p}(s + (1 - s)h) + (1 - \bar{p})s} C_{NA}^2 ;$$

Given the switching decisions of individuals, the price charged by new insurers to customers who report zero past claims reflects the fact that the pool of such customers

includes some customers who had a claim and are not reporting it and some customers who did not have a claim and are switching due to a shock. The above price reflects the average cost in the pool of switchers who report zero past claims.

As to first-period insurers, these insurers will charge their remaining customers C_{S-RNA}^2 if they did not have an accident in the first period and C_A^2 if they had an accident in the first period. Given that new insurers charge switchers who report no past claims a price of C_{S-RNA}^2 , there is no reason for current insurers to charge their remaining customers who had no past claims less than this price. As to customers who had an accident, current insurers will charge them an amount of C_A^2 , which is their cost, and which is what they would be able to obtain if they were to go into the market and reported their past claim.

Finally, in the unique equilibrium, insurers will charge new customers at $T = 1$ a price that is below the break-even price for the first period defined by:

$$P^1 = C^1 - (C_{S-RNA}^2 - C_{NA}^2)(1-s)(1-\bar{p})$$

For any given new customer attracted at $T = 1$, the insurer can anticipate making an expected profit from this customer in the second period. With probability $(1-\bar{p})(1-s)$, the policyholder will not have an accident and will not have a shock leading to departure, and in such a case the insurer will be able to make expected profit of $C_{S-RNA}^2 - C_{NA}^2$. Thus, competition for new customers at $T = 1$ will drive the price to P^1 .

The above analysis yields three testable predictions:

Hypothesis H1: Profits on repeat customers will be higher than on new customers with the effect driven by profits on repeat customers with a good past record.

Customers with a good claim record know that, if they were to switch to a new insurer, they would be pooled with some customers with bad records. Therefore, they would not be able to obtain from a new insurer a price that fully reflects their low risk which is known to their current insurer. Thus, the current insurer will not have to offer them a price fully reflecting this low risk to keep them.

Hypothesis H2: Relative to repeat customers with bad past claim records, repeat customers with a good past claim record will be charged lower premia and generate lower costs, with the reduction in premium associated with customers with good claim records being lower in magnitude than the reduction in cost associated with such customers.

In the asymmetric learning model, the profits made on repeat customers with good records are not driven by charging them higher prices than new customers. Rather, they are driven by the low risk and thus low costs of these customers.

Hypothesis H3: Customers with good records will disproportionately remain with the insurer for another period.

In the asymmetric learning model, customers with a bad record, but not ones with a good record, will have an incentive to flee to new insurers to pool themselves with customers with a good record that leave due to an exogenous shock.

3 Data and Summary Statistics

The paper is based on data that I received from an insurer that operates in the market for automobile insurance in Israel. The data consists of a panel of about 120 thousand individuals who purchased policies from the insurer during the period 1994-2000. During this period, the insurer held between 5% and 10% of the Israeli insurance markets. A

subset of the data consisting of information about new customers in their first year was used in Cohen (2005) to study adverse selection among such customers, as well as by Cohen and Einav (2007) to study risk preferences among these customers. This paper takes advantage of the fact that the dataset also includes information about customers that are repeat customers to study the insurer's learning about, and its transactions with, repeat customers.

Overall, the dataset contains about 267 thousand observations (policies). For each observation (policy), the dataset contains information about the policyholder's demographic characteristics (such as age, gender, education, family status, place of birth, and immigration year), the policyholder's car characteristics (such as model year, value of the car, size of engine, commercial vehicle or not, main vehicle or not), policyholder's driving characteristics (such as years since getting driving license, number of claims in past three years, young driver or not, etc.).

The dataset also contain information about the terms of the policy. In the Israeli insurance market, policies are fairly standardized in terms of their structure. Two types of deductibles are used, referred to as a regular deductible and a low deductible. I focus on the subset of individuals who chose regular deductible when joining the insurer, which consist of 80% of the policies. Customers generally remain with the same type of deductible when they renew their policies, and these individuals have thus generally remained with a regular deductible throughout their dealings with the insurer. Because the regular deductible is the highest deductible used in the Israeli insurance market, the individuals in the subset of the data on which I focus could not signal being of a low-risk type to a rival insurer by choosing a higher deductible.

In addition, the dataset contains information about the realization of risks covered by the policy – that is, the number of claims submitted by the policyholder, the amount of damages reported, and the amount paid (or expected to be paid) to the insured by the insurer. The dataset also contains information about the period during which the policy was open, which enables calculation of the earned premium in the event that a policy was open for less than the full policy period.⁹ Throughout the paper, I report monetary values in current (nominal) New Israeli Shekels (NIS) to avoid creating artificial variation in the data.¹⁰

I exclude the last year because I do not have the full realization of the policies for that year, and am thus left with 6 years of operation, 1994-1999. After excluding the last year and retaining only policies with regular deductible levels, the dataset used for this study contains about 218 thousand policies purchased by about 102 thousand policyholders.

Table 1 displays summary statistics about the distribution of company experience among policyholders. Among the policies in the dataset, 46.7% were sold to new customers with no prior experience at the company, 26% were sold to policyholders who already had one year of experience with the company, 14.6% were policies sold to

⁹ Insurer's earned premium is equal to the quoted annual premium weighted by the exposed time of the policy. Policyholders who cancel a policy before it expires have to pay only for the period during which the policy was exposed and get a refund if necessary.

¹⁰ The following facts may be useful for interpretation and comparison with other papers in the literature. The exchange rate between NIS and U.S. dollars monotonically increased from 3.01 in 1995 to 4.14 in 1999 (on average, it was 3.52). Annual inflation was about eight percent on average, and cumulative inflation over the observation period was 48 percent. I will account for these effects, as well as other general trends, by using year dummy variables throughout the analysis.

policyholders who had two years of experience with the company, and 12.7% were policies sold to policyholders who had been with the company for three or more years.

Table 2 provides summary statistics about policyholder characteristics for different levels of company experience. As expected, the Table indicates that policyholders with more years of company experience have a somewhat higher average age. The pools of policyholders with different levels of company experience do not exhibit substantial differences in terms of gender composition or mean car value.

As Table 2 indicates, however, there are substantial differences among the pools of policyholders with different levels of company experience in terms of claim frequency, premia, and costs. Claim frequency is substantially lower among pools of policyholders with more company experience, with the frequency declining from 21% among policyholders with no company experience to 14% among policyholders with three or more years of company experience. As expected, the average cost (insurance payment) per policy is lower for pools of policyholders with more company experience, declining from over 1,650 NIS for policyholders with no company experience to below 1,200 NIS for policyholders with three or more years of company experience.

Table 2 also indicates that average premium is also lower for pools of policyholders with more company experience. The average premium declines from 2,262 NIS for policyholders with no company experience to 2,208 NIS for policyholders with one year of company experience, to 2,036 NIS for policyholders with three years of company experience, and to 2,001-2,003 NIS for policyholders with four-five years of company experience. Note that, as we move from pools with no company experience to ones with

more company experience, the decrease in average premium accompanying the move is smaller in magnitude than the accompanying decrease in average costs.

Given the above observations, it is unsurprising that Table 2 also indicates that the profitability of policyholder pools is higher for pools with more company experience. In the insurance market, the profitability of pools of policies is generally assessed by the loss ratio – the percentage of the aggregate premia earned by the insurer that is paid out as insurance payments to policyholders submitting claims. The profit ratio, which is equal to one minus the loss ratio, is thus correspondingly the percentage of aggregate earned premia that is retained by the insurer after making all insurance payments to policyholders submitting claims. In my dataset, the profit ratio is 25% for the pool of policyholders with no company experience, 31% for the pool of policyholders with one year of company experience, 35% for the pool of policyholders with two years of company experience, and over 40% for all the pool of policyholders with three or more years of company experience.

4. Empirical Analysis

I now turn to the empirical analysis of the dataset. I first examine the relation of profit and the insurer's possession of information (not shared by other insurers) about a policyholder's low risk (section 4.1). To understand the obtained results, I then look beyond profits at the two elements determining these profits – premia charged and costs incurred – and study the relation of each of these elements and the insurer's possession of such information (section 4.2). Finally, I look at the relation of customers' switching

decisions and the insurer's possession of information about a customer's low risk (section 4.3). Throughout, I conduct the analysis both at the level of individual policies level and at the aggregate level of policy pools. I use the aggregate, grouped approach both as a robustness check and because the insurance industry commonly assesses pools of policies by examining their aggregate performance.

4.1. Profits and the Insurer's Learning

I first test whether the insurer makes higher profits on policies sold to policyholders who are known to the insurer – but not to the same extent to other insurers – to be of low risk. For the insurer to have such information about a policyholder, the insurer needs both to have a company record about the policyholder and for the record to be one with good claim history. Below I therefore test (i) whether the insurer makes higher profits on repeat customers, (ii) whether these higher profits are driven by transactions with customers with a good company record, and (iii) whether these profits are highest when the policyholder has had a good company record with the insurer for a relatively long period of time.

4.1.1. Individual Data

Table 3, panel A presents the results of a Tobit regression of the profitability of individual policies. Throughout, the dependent variable is the profit ratio, which is defined as the ratio of the insurer's profit from selling the policy to the earned premium. The insurer's profit from selling the policy is equal to the earned premium minus the cost of insurance payments if any. I use Tobit regressions because the dependent variable is

censored from above at 1 (85% of the policies were not involved in a claim and have a profit ratio equal to this upper bound of 1).

In all the regressions, in addition to the variables that are my chief interest, I use as controls the policyholder's age, the value of the policyholder's car, and a dummy variable indicating whether the policyholder is a male. I also control for year fixed effects.¹¹

Company experience is of course necessary for learning. In the first regression, displayed in column 1 of Table 3, the dependent variable of interest is company experience defined as the number of years of company experience that the policyholder has. The coefficient of experience is positive and significant (at 99% level).

Of course, the ability of sellers to make higher profits on repeat customers could result from non-informational switching costs that enable the seller to charge high prices to customers for whom a switch would be costly.¹² Unlike in a model with non-informational switching costs, however, under the asymmetric learning model, what matters for the insurer's ability to make higher profits is not merely company experience but a company experience that provides the seller with positive information that the customer has low risk. It is only with respect to such customers that the insurer could have information-based market power. In contrast, the insurer cannot have an information-based market power over repeat customers who have a poor record with the

¹¹ Asymmetric learning theory does not predict that profits for the same customers will increase with company experience. Rather, in this model, profits are higher on repeat customers because high-risk, bad-claims-record customers tend to depart, and repeat customers thus disproportionately come from the subset of beginning customers who have low risks. For this reason, I do not test for asymmetric learning model using regressions with individual policyholder fixed effects, as such regressions focus on over-time variation in profit ratios for the same individuals.

¹² The literature on switching costs is large. See, e.g., Dahlby and West (1986), Nilssen (1992), Klemperer (1995), Shy (2002), and Stango (2002).

insurer and thus have little to lose in terms of their perceived risk type if they switch to a rival insurer.

Therefore, in a regression displayed in the second column of Table 3, I add a dummy variable indicating whether the policyholder has a good company record. With the addition of this variable, company experience is no longer statistically significant. Having a good company record is positive and significant (at 99% level).

The extent to which not having past claims is indicative of being of low risk depends, of course, on the length of period during which the policyholder did not have a claim. That is, the asymmetric learning model predicts that the extent to which a good company record matters should depend on company experience. I therefore add, in a regression displayed in the third column of Table 3, an interaction term of the good company record dummy and company experience. The interaction term is positive and significant (at the 99% level). In this regression, neither good company record by itself, nor company experience by itself, are positive and significant (good company record is not significant, and company experience is significant and negative).

A specification that uses company experience implicitly assumes that each extra year of good record is equally useful in terms of providing the insurer with information about the customer's risk. For robustness check, I replace company experience with its log in a regression displayed in the fourth column of Table 3. The results remain essentially the same.

In the fifth and final column of Table 3, I use a piecewise specification that allows for company experience to make a different contribution up to the three years of company experience and from this point on. In particular, I replace company experience with two

variables: one that is equal to the maximum between 3 and the policyholder's company experience; and one that is equal to the minimum between 0 and the excess of the policyholder's company experience over 3. The regression also includes the interaction terms of good company record with the two new variables.

The interaction terms of good record and extra experience up to 3 years is positive and significant (at 99% level). The interaction term of good record and extra experience beyond three years is insignificant. These results indicate that, after a customer has three years of no claims history with the insurer, the customer's low risk is sufficiently well established that another year or two of no claims do not matter much.

4.1.2. Grouped data

The second approach that I use is based on grouped data. I divide all the policies in the dataset into sub-groups in two ways. The first partition divides the dataset according to the customer's years of company experience, whether the customer had a good company record, and the calendar year to generate sub-groups of policies that have the same number of years of company experience, the same value for the good company record variable, and the same calendar year. This division results in 38 groups.

I run on these 38 groups an OLS regression in which the dependent variable is the group's profit ratio. In the grouped data, profit ratio is defined as the ratio of the aggregate profit generated by the group to the aggregate earned premium produced by this pool of policies. The aggregate profit generated by the group is equal to the aggregate earned premium from the pool of policies minus the aggregate insurance payment resulting from the pool of policies.

Table 3, panel B displays the results of a regression that corresponds in nature to the regression in the second column in panel A of Table 3. The independent variable of interest is a dummy variable indicating whether the group is made of policyholders with a good company record and the number of years of company experience that the policyholders in the pool have. As controls, I use the average policyholder age, the average car value, and the proportion of males for each pool of policies. I weight the regression by the number of observations in each pool.

The results indicate that the company makes higher profits on pools of policies purchased by policyholders with a good company record with the insurer. The coefficient of good company record is positive and significant at the 99% level. Controlling for other characteristics of the pool of policies, a pool of policies with a good claims record has a profit ratio higher by 0.058 (5.8%). To put this effect in context, we could compare it to the mean profit ratio in the pools of policies which is 0.317 (31.7%). Thus, having policyholders with good claims record has a positive effect on the profit ratio with a magnitude that is almost one-fifth of the mean level of the profit ratio among the pools of policies.

Because the first partition results in only 38 groups, I proceed to a finer partition of the dataset into a larger number of groups of policies. In this second partition into groups, in addition to dividing the dataset as before according to (i) the customer's years of company experience, (ii) whether the customer had a good company record, and (iii) the calendar year, I also divide the dataset according to (iv) the customer's age group (dividing the customers into four different age groups), (v) the customer's gender, and (vi) the car value group of the customer (dividing the customers into four car value

groups). This second method of division results in 1154 groups of policies, with each group including policies that are identical to each other along each of the six dimensions (i)-(vi).

I run on the 1154 groups three OLS regressions with the group's profit ratio as the dependent variable. As to the explanatory variables, I use specifications similar to those used for the individual policy data in columns (3)-(5) of panel A of Table 3. The results are displayed in columns (2)-(4) of panel B of Table 3. The regressions yield similar results to the ones obtained in the corresponding columns of Table 3, panel A.

Thus, overall, both the regressions based on individual data and the regressions based on grouped data produce results consistent with the asymmetric learning model. The insurer makes larger profits on repeat customers with good past records, but not on repeat customers without such record, and the magnitude of the profits made on customers with a good past record increases with the length of period through which the customers have obtained this record. Thus, the insurer's profit is associated with the insurer's having private information about a customer's low risk.

4.2. Premia, Costs, and the Insurer's Learning

We have thus far seen that, consistent with the asymmetric learning theory, the insurer makes, controlling for company experience, higher profits on customers who have a good record with the insurer and for whom the insurer thus has private information indicating a low risk. I now turn to look beyond these high profits at the two elements defining profits – the premia (prices) charged to customers, and the costs (insurance payments) generated by customers – and to study the relation of each of these

elements and the insurer's possession of private information about customers' low risk. The prediction of the asymmetric learning model, which I examine below, is that the profits made on repeat customers with a good past company record is driven not by charging these customers higher prices but by the lower costs generated by such customers. As before, I conduct the testing twice, once using individual policy data and once using grouped data.

4.2.1 Individual Data

Table 4, panel A, column (1) provides the results of an OLS regression on all individual policy in which the dependent variable is the customer's premium. The independent variable of interest is a dummy variable indicating whether the customer has a good claim history record with the insurer, as well as an interaction term interacting company experience with the good past record dummy. I control for the customer's company experience, the customer's age, the customer's gender, and the value of the customer's car, as well as for year fixed effects.

The results indicate that the coefficient of good company record is negative and significant (at the 1% confidence level). Furthermore, the coefficient of the interaction term is negative and significant (at the 1% confidence level). Thus, the effects of good record is larger when the good record was obtained over a longer period – that is, the more substantial the insurer's private information about the customer's low risk.

If repeat customers with good claim history are not charged higher premia by the insurer, the higher profits generated by transacting with such customers can come only from the lower costs (insurance payments) generated by such customers. I therefore next

run two regressions on all individual policies – one in which the dependent variable is the cost to the insurer of the policy, and one in which the dependent variable is the number of claims generated by the policy. In the cost regression, I use a Tobit regression because the dependent variable is censored from below by 0 (recall that the 85% of the policies were not involved in a claim). In the number of claims regression, I use a negative binomial regression.

As before, the independent variables of interest are a dummy variable indicating whether the customer has a good claim history record with the insurer and a variable interacting company experience with the good past record dummy. I continue to control for the customer's company experience, the customer's age, the customer's gender, and the value of the customer's car, as well as for year fixed effects.

The results are displayed in columns (2) and (3) of panel A of Table 4. The coefficient of good claim record is negative and significant (at the 1% confidence level) in both the cost regression and the number of claims regression. Furthermore, the coefficient of the interaction term of good claim history and company experience is negative and significant (at the 1% confidence level) in both regressions. Thus, costs are lower when the insurer has private information based on past claim history suggesting low risk, and the magnitude of this association is larger when the insurer's private information is substantial and based on a sufficiently long period.

It is instructive to compare the sizes of the coefficients of interest in the premium regression and the cost regression. While the coefficient of having a good claim record is negative in both the premium and cost regressions, the size of this coefficient is more than 10 times larger in the latter regression than in the former regression. Similarly, while

the coefficient of the interaction of good claim record and company experience is negative in both regressions, the size of this coefficient is also more than 10 times larger in the latter regression than in the former regression.

The above pattern explains the source of higher profits documented with respect to repeat customers with good claim history (see Table 3, panel A). Consistent with the asymmetric learning model, these customers receive from the insurer a lower reduction in premium charged than would be necessary to reflect fully the lower costs that these customers are expected to generate based on the insurer's private information of their good claim record.

4.2.2 Grouped Data

I now turn to examine the relation between premia and costs and the insurer's possession of private information about customers' low risks using grouped data. I use for this purpose the partition into 1154 groups of policies with identical covariates along six dimensions that I used in the preceding section.

Table 4, panel B, columns (1)-(3) provides the results of three regressions that are similar in nature to the regressions of columns (1)-(3) of Table 4, panel A. The dependent variables in the regressions are, respectively, the average premium per policy, the average cost per policy, and the average number of claims per policy for each group of policies.

Each of the three regressions has two independent variables of interest for any given group of policies: (i) a dummy indicating whether the policyholders in the pool have a good past claims record at the company, and (ii) an interaction variable interacting the good past claim history dummy with the level of company experience of the

policyholders in the group. In each of the three regressions, I control for the level of company experience of the policyholders in the group; the age group of the policyholders in the pool; the car value group of the policyholders in the pool; the gender of the policyholders in the pool; and the year in which the policies in the pool were issued.

Consistent with the findings in panel A, the coefficient of the interaction term of company experience and having a good past claims record is negative and significant (at the 1% confidence level) in each of the three regressions. Thus, pools of policies with a good claim record are associated with lower average premium per policy, lower average costs per policy, and lower number of claims per policy to an extent that increase with the length of the period during which the good claim record was obtained. Furthermore, the size of the negative coefficient of the interaction variable is higher in the average cost per policy regressions than in the average premium per policy regression.

Overall, the results using grouped data are consistent with those obtained earlier using individual data. The existence of private information indicating low risk in the hands of the insurer is associated with lower costs and with a reduction in premium that is lower in magnitude than the cost reduction and thus creates the potential for profits.

4.3 Switching Decisions and the Insurer's Learning

Finally, I turn to examining a third prediction of the asymmetric learning model. Under the asymmetric learning model, the lower risks generated by repeat customers, which I documented in the preceding section, are due to policyholders' switching decisions. In the asymmetric learning model, the lower risks posed by repeat customers, and the lower costs (insurance payments) generated by such customers, result from the

disproportionate tendency of customers with good past records, who are likely to pose lower risks, to remain with the insurer, as well as the disproportionate tendency of customers without good past records, who are likely to pose higher risks, to flee from their bad records by switching to another insurer. I now turn to testing whether this is the case.

Table 5, column (1) displays the results of a logit regression on the set of all individual policies in which the dependent variable is a dummy indicating whether the policyholder elected to stay with the insurer for another period at the end of the policy period. The dependent variable of interest is whether the policyholder has a good company record. I use as controls the policyholder's company experience, the policyholder's age, the value of the policyholder's car, and a dummy variable indicating whether the policyholder is a male.

Column (2) of Table 5 displays the results of an OLS regression based on aggregate, grouped data. I use again the partition of the policies into 1154 policy groups used earlier. I run an OLS regression in which the dependent variable is the fraction of the policyholders in the pool who elected to stay with the insurer for another year at the end of the policy period. The dependent variable of interest is whether the policyholders in the group of policies had a good past claims record with the insurer. As controls, I use the age group of the policyholders in the pool, the car value group of the policyholders in the pool, the gender of the policyholders in the pool, the level of company experience of the policyholders in the pool, as well as the year in which the policies in the pool were issued.

Both regressions produce results that are consistent with the asymmetric learning model. In both regressions, the coefficient of a good company record is positive and significant at the 99% level. In the individual policies regression, the coefficient is 1.294, which implies that the probability of remaining with the insurer for another period is 1.29 times higher if the policyholder has a good past record with the insurer. In the grouped data regression, the coefficient is 0.06, which implies that another 6% of the policyholders in a pool will remain with the insurer for another period if the policyholders in the pool have a good claims record. Thus, remaining with the insurer for another period has an economically meaningful association with the insurer's possession of private information indicating that the customer is of a low risk.

5 Conclusion

This paper has used a unique and rich panel dataset obtained from an insurance company to test empirically the existence of asymmetric learning in markets with repeated contracting. Consistent with the predictions of asymmetric learning theory, I find that the insurer makes higher profits on policies sold to its repeat customers and that these profits are driven by profits on repeat customers who had a good company record with the insurer; that these profits are generated not by charging higher premia but rather by the lower costs (and number of claims) generated by policyholders with a good company record and the insurer's not providing these policyholders with a discount fully reflecting their low risk; and that the high quality of the pool of repeat customers'

policies is produced by the greater tendency of customers with bad records to leave the insurer. The study thus provides evidence that is consistent with the theoretical literature on asymmetric learning in markets with repeated contracting.

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Appendix: Variable definitions

Academic Degree	A dummy variable that is equal to 1 if the insured have an academic degree and 0 otherwise.
Male	A dummy variable that is equal to 1 if the insured is a male and 0 otherwise.
Relative Car Value	The car value divided by the mean value of the cars at that year.
CC Weight	The volume of the engine in cubic centimeters (cc). This is a measure of size and power.
Main Vehicle	A dummy variable that is equal to 1 if the car is not the main car in the household.
Use of the car	A dummy variable that is equal to 1 if the policyholder uses the car for business.
Experience	Number of years the policyholder stayed with the company.
Experience for Customers with No Company Claims	Equal to experience if the policyholder had no claims during his years with the company and 0 otherwise.
Experience for Customers with Company Claims	Equal to experience if the policyholder had claims during his years with the company and 0 otherwise.
No Company Claim	A dummy variable that is equal to 1 if the policyholder had no claims during his years within the company and 0 otherwise.

TABLE 1: DISTRIBUTION OF COMPANY EXPERIENCE

Company Experience	Number of policies	Percent	Cum.
0	101,825	46.75	46.75
1	56,660	26.01	72.76
2	31,731	14.57	87.32
3	17,050	7.83	95.15
4	8,064	3.7	98.85
5	2,498	1.15	100
Total	217,828	100	

TABLE 2: SUMMARY STATISTICS OF POLICY CHARACTERISTICS

Company Experience	0	1	2	3	4	5
<u>Policyholder and policy Characteristics</u>						
Age	41.35 (12.33)	43.33 (12.41)	44.69 (12.48)	46.11 (12.63)	47.34 (12.70)	48.68 (12.90)
Male	0.67 (0.47)	0.66 (0.47)	0.66 (0.47)	0.67 (0.47)	0.68 (0.47)	0.72 (0.45)
Car value	59,820 (33,091)	55,515 (30,403)	52,840 (29,193)	52,349 (29,310)	53,362 (30,366)	54,977 (31,904)
Number of Claims	0.21 (0.47)	0.19 (0.45)	0.17 (0.42)	0.16 (0.41)	0.14 (0.38)	0.14 (0.40)
Average Costs	1684 (8023)	1512 (7372)	1356 (6746)	1187 (6147)	1146 (6009)	1191 (6468)
Average Premium	2262 (945)	2208 (859)	2096 (811)	2036 (765)	2003 (751)	2001 (733)
Aggregate Profit Ratio	0.255	0.315	0.353	0.417	0.428	0.405

- Standard error in parenthesis

TABLE 3: PROFITS AND RECORD IN THE COMPANY

PANEL A: INDIVIDUAL DATA

Dependent variable: Profit Ratio

Variable:	(1)	(2)	(3)	(4)	(5)
Company Experience	0.461*** (0.086)	-0.103 (0.103)	-0.839*** (0.136)		
Log (Company experience)				-2.031*** (0.294)	
Good Record		2.208*** (0.235)	0.443 (0.304)	-0.532 (0.450)	0.247 (0.354)
Min(Company Experience,3)					-1.076*** (0.175)
Max(Company Experience-3,0)					0.732 (0.672)
Experience x Good Record			1.600*** (0.197)		
Log Experience x Good Record				4.367*** (0.530)	
Min(Company Experience,3) x Good Record					1.946*** (0.265)
Max(Company Experience-3,0) x Good Record					-0.349 (0.814)
Age	0.040*** (0.007)	0.039*** (0.007)	0.745*** (0.248)	0.756*** (0.248)	0.749*** (0.246)
Car Value	-0.00003*** (3.04e-06)	-0.00002*** (3.02e-06)	-0.00003*** (3.01e-06)	-0.00003*** (3.01e-06)	-0.00003*** (3.01e-06)
Male	-0.227 (0.191)	-0.224 (0.189)	-0.241 (0.189)	-0.242 (0.188)	-0.244 (0.188)
Number of Observations	217594	217594	217594	217594	217594
Year fixed effect	Yes	Yes	Yes	Yes	Yes

- Significant at 10%; ** significant at 5%; *** significant at 1%
- Standard error in parenthesis

TABLE 3: PROFIT, EXPERIENCE, AND RECORD IN THE COMPANY (Cont.)

PANEL B: GROUPED DATA
 Dependent variable: Profit Ratio

Variable:	(1)	(2)	(3)	(4)
Company Experience	-0.037 (0.044)	-0.028*** (0.01)		
Good Record	0.007 (0.032)	0.004 (0.023)	-0.013 (0.034)	0.004 (0.027)
Log Company Experience			-0.064*** (0.023)	
Min(Company Experience,3)				-0.032** (0.013)
Max(Company Experience-3,0)				-0.001 (0.055)
Experience x Good Record	0.058*** (0.017)	0.042*** (0.014)		
Log Experience x Good Record			0.107*** (0.038)	
Min(Company Experience,3) x Good Record				0.046** (0.019)
Max(Company Experience-3,0) x Good Record				0.017 (0.063)
Mean Age	0.03 (0.032)			
Mean Car Value	0 (0)			
Male	-0.961** (0.439)			
Age Qrt2		0.014 (0.019)	0.014 (0.019)	0.014 (0.019)
Age Qrt3		0.058*** (0.02)	0.05*** (0.02)	0.06*** (0.02)
Age Qrt4		0.107*** (0.02)	0.107*** (0.02)	0.107*** (0.02)
Car Value Qtr2		-0.061*** (0.019)	-0.061*** (0.019)	-0.061*** (0.019)
Car Value Qtr3		-0.089*** (0.019)	-0.089*** (0.019)	-0.089*** (0.019)
Car Value Qtr4		-0.151*** (0.019)	-0.151*** (0.019)	-0.151*** (0.019)
Male		-0.050*** (0.015)	-0.050*** (0.015)	-0.050*** (0.015)
Observations	38	1154	1154	1154
Year fixed effect	Yes	Yes	Yes	Yes
R-squared	0.92	0.2621	0.2626	0.2610

- Significant at 10%; ** significant at 5%; *** significant at 1%
- Standard error in parenthesis

TABLE 4: PREMIUMS, COSTS, AND CLAIM FREQUENCY

PANEL A: INDIVIDUAL DATA

	(1)	(2)	(3)
Dependent Variable:			
Variables:	Premium	Cost	Number of Claims
Good Record	-27.869*** (4.498)	-525.464** (265.413)	-0.043** (0.018)
Experience x Good Record	-115.159*** (3.288)	-1534.82*** (165.743)	-0.115*** (0.011)
Company Experience	29.373*** (2.839)	715.776*** (114.290)	0.050*** (0.007)
Age	-1.314*** (0.147)	-42.345*** (6.310)	-0.002*** (0.0004)
Car Value	0.016*** (0.0001)	0.049*** (0.003)	1.7e-06*** 1.61e-07
Male	8.459** (3.941)	367.581** (162.723)	0.019* (0.011)
Observations	217828	217828	217828
Year fixed effect	Yes	Yes	Yes
R-squared/Pseudo R-squared	0.3079	0.0015	

- Significant at 10%; ** significant at 5%; *** significant at 1%
- Standard error in parenthesis

TABLE 4: PREMIUMS, COSTS, AND CLAIM FREQUENCY (CONT.)

PANEL B: GROUPED DATA			
	(1)	(2)	(3)
Dependent Variable:			
Variables:	Premium	Cost	Number of Claims
Good Record	-36.348*** (10.57)	-57.32 (56.25)	-0.013*** (0.003)
Experience x Good Record	-113.48*** (6.50)	-159.84*** (34.57)	-0.018*** (0.002)
Company Experience	20.21*** (4.75)	75.07*** (25.28)	0.009*** (0.002)
Age Qrt2	-111.58*** (8.8)	-108.38** (46.83)	-0.013*** (0.003)
Age Qrt3	63.08*** (8.89)	-94.21** (47.29)	-0.005 (0.003)
Age Qrt4	-50.89*** (8.97)	-275.42*** (47.73)	-0.014*** (0.003)
Car Value Qtr2	283.50*** (8.79)	302.48*** (46.78)	0.014*** (0.003)
Car Value Qtr3	568.552*** (8.80)	557.15*** (46.83)	0.020*** (0.003)
Car Value Qtr4	1173.13*** (8.60)	1155.90*** (45.74)	0.030*** (0.003)
Male	26.15*** (6.61)	125.72*** (35.20)	0.003 (0.002)
Observations	1154	1154	1154
Year fixed effect	Yes	Yes	Yes
R-squared	0.9564	0.4436	0.5194

- Significant at 10%; ** significant at 5%; *** significant at 1%
- Standard error in parenthesis

TABLE 5: STAYING DECISIONS AS A FUNCTION OF RECORD IN THE COMPANY

	Individual Data	Grouped Data
Dependent variable:	Stay Dummy (odds ratio)	Fraction of Staying Policyholders
Variable:		
Company Experience	1.033*** (0.005)	0.009*** (0.002)
Good Record	1.294*** (0.015)	0.055*** (0.004)
Age	1.019*** (0.0004)	
Age Qrt2		0.075*** (0.004)
Age Qrt3		0.077*** (0.004)
Age Qrt4		0.130*** (0.004)
Car Value	1.000003*** (1.62e-06)	
Car Value Qtr2		0.080*** (0.004)
Car Value Qtr3		0.085*** (0.004)
Car Value Qtr4		0.077*** (0.004)
Male	0.913*** (0.01)	-0.035*** (0.003)
Observations	217828	217828
Year fixed effect	Yes	Yes
Pseudo R-squared	0.0365	0.8110

- significant at 10%; ** significant at 5%; *** significant at 1%
- Standard errors in parentheses