Estimating Private Information in the Insurance Markets when Agents have Heterogeneous Risk Preferences

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The standard test for asymmetric information in insurance markets fails to detect the effects of private information if agents have heterogeneous risk attitudes. Finkelstein and McGarry (2006) illustrate this for the market of long-term care insurance by providing direct evidence for the existence of private information. We show that under certain conditions it is possible to detect asymmetric information without direct evidence of private information - even if agents have heterogeneous risk attitudes. We apply our technique to the market for long-term care insurance and confirm the results of Finkelstein and McGarry, without relying on direct evidence of private information. Our methodology is applicable to other insurance markets. It is especially useful in markets where proxies for private information are not available.