

Screening and Adverse Selection in Frictional Markets*

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Abstract

We develop a tractable framework for analyzing adverse selection economies with imperfect competition. Applications include markets for insurance, loans and financial assets. In our environment, uninformed buyers offer a general menu of screening contracts to trade with a privately informed seller. Imperfect competition is captured by allowing some sellers to trade with multiple buyers while others can only trade with one buyer (as in Burdett and Judd (1983)). Thus, the framework allows us to consider variations to the degree of competition in the market where one extreme is perfect competition à la Rothschild and Stiglitz (1976) while the other extreme is the standard non-linear pricing problem of a monopolist. We show that the unique symmetric mixed strategy equilibrium can be summarized by a probability distribution of indirect utilities offered by each buyer to each type of seller. Furthermore, we prove that the equilibrium exhibits a strict rank-preserving property, in that different types of sellers have an identical ranking of different menus offered in equilibrium. The equilibrium features menus

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that are all separating, all pooling or a mixture of both. When both types of menus are offered in equilibrium, those which offer higher utility to the seller are more likely to be separating. Ex-ante welfare is maximized when competition is imperfect. Finally, we study the effects of various policies - such as mandates, non-discrimination requirements and other restrictions on contracts - on welfare and the extent of competition.