Insurance Demand Anomalies: An Interpretation from Rank Dependent Expected Utility Theory

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Abstract

One of long-standing puzzles on insurance demands is that there is a greater demand for insurance for high probability, low consequence (HPLC) events than for insurance for low probability, high consequence (LPHC) events. This article examines the possibilities of theoretical explanation of the puzzle on the basis of rank dependent expected utility theory in combination with time-inconsistent preference theories. This paper shows that under the circumstance where people face risks that are stochastic in time, rank dependent utilities with S-shaped probability weighting function would be plausible, and the utilities can be consistent with the biased insurance demand.

Key words: Time Preference; Rank Dependent Expected Utility; Insurance Demand.
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