Market Structure and Adverse Selection

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Abstract

This paper adopts a unified perspective on multi-contracting in competitive markets plagued by adverse selection. We subsume the two polar cases of exclusive and non-exclusive competition by introducing the concept of a market structure, i.e., a trading rule that specifies the subset of sellers with whom buyers can jointly trade. The existing literature shows that the market structure matters greatly in shaping competitive allocations, allowing for either separating allocations (as shown by Rothschild-Stiglitz) or layered pooling (Jaynes-Hellwig-Glosten) allocations. We prove the existence of intermediate "Pooling + Separating" equilibria that allow for simultaneous pooling and low-risk buyer separation. Crucially, those allocations alleviate at the same time the concern of excessive rationing under separation of and cross-subsidies paid by low-risk buyers. They oftentimes Pareto dominate the Rothschild-Stiglitz separating allocation. Our analysis singles out the "1+1" market structure where sellers are separated into two subgroups so that buyers can trade with at most one seller from each subgroup. Any "Pooling + Separating" allocation is an equilibrium here. Finally, we prove that "Pooling + Separating" allocations satisfy a notion of stability that we call serendipitous-aftermarket-proofness