Investigating the Impact of Honesty in Insurance and Trading Using Game Theory Models

Dartmouth Mathematics REU

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Outline

1 Project Overview

2 Insurance Fraud Model
   Methods and Results
   Discussion
   Summary

3 Trading Model
   Methods
   Results and Discussion
   Summary
Do you know how much money insurance fraud steals from the insurance industry every year?
Over 80 Billion Dollars!

(That’s worth 50,031,269.54 MacBooks)
We would like to build a mathematical system to better enforce honesty in the society

- Insurance fraud model: to investigate the fraudulent or honest behavior of policy holders regarding the change of the policy holders’ claim amount or profit amount
- Trading model: to observe the behavior of investees with the enforcement of investment rules regarding honesty
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   Methods and Results
   Discussion
   Summary

3. Trading Model
   Methods
   Results and Discussion
   Summary

Works Cited
In the study titled "Investigating the Impact of Honesty in Insurance and Trading Using Game Theory Models," Sissi Chen, Ru Yin Hing, and Chi Zhang explore the effects of honesty in various scenarios.

### Project Overview

#### Insurance Fraud Model

#### Methods and Results

#### Discussion

#### Summary

### Trading Model

#### Methods

#### Results and Discussion

#### Summary

### Works Cited

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#### Payoff Matrix

<table>
<thead>
<tr>
<th></th>
<th>PH</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>IN</strong></td>
<td><strong>Fraud</strong></td>
</tr>
<tr>
<td>No Inv.</td>
<td>$(-(s + p), p)$</td>
</tr>
<tr>
<td>Inv.</td>
<td>$(kp - c, -(s + kp))$</td>
</tr>
<tr>
<td><strong>Honest</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$(-s, 0)$</td>
</tr>
<tr>
<td></td>
<td>$(-(c + s), \delta)$</td>
</tr>
</tbody>
</table>

*IN: Insurance Company, PH: Policyholder*
Model and Notations

<table>
<thead>
<tr>
<th>IN</th>
<th>No Inv.</th>
<th>Inv.</th>
</tr>
</thead>
<tbody>
<tr>
<td>PH Fraud</td>
<td>$(-(s + p), p)$</td>
<td>$(-s, 0)$</td>
</tr>
<tr>
<td>PH Honest</td>
<td>$(kp - c, -(s + kp))$</td>
<td>$(-(c + s), \delta)$</td>
</tr>
</tbody>
</table>

- $S$: honest claim amount of PH
- $P$: potential profit of PH if PH commits fraud
- $C$: cost of each secondary investigation of IN
- $K$: percentage on potential net fraud profit ($P$), which represents fine on fraudulence PH if IN realizes the fraud
- $\delta$: benefit for PH, if IN carries out deep investigation and realizes PH is honest
Nash Equilibrium Point

From replicator equations:

\[
\dot{x}_i = x_i ((Ay)_i - x \cdot Ay), \quad i = 0, \ldots, n
\]

\[
\dot{y}_j = y_j ((Bx)_j - y \cdot Bx), \quad j = 0, \ldots, m
\]
From replicator equations:

\[ \dot{x}_i = x_i ((Ay)_i - x \cdot Ay), \quad i = 0, \ldots, n \]
\[ \dot{y}_j = y_j ((Bx)_j - y \cdot Bx), \quad j = 0, \ldots, m \]

\(x1\) represents the probability that IN does not investigate

\(y1\) represents the probability that PH tends to fraud

We obtain the equilibrium point by setting change in speed to 0:
Nash Equilibrium Point

\[ x_1 = \frac{kp + s + \delta s}{p + kp + s + \delta s} \]

\[ y_1 = \frac{c}{p + kp + s} \]

\( x_1 \) represents the probability that IN does not investigate

\( y_1 \) represents the probability that PH tends to fraud
Investigating the Impact of Honesty in Insurance and Trading Using Game Theory Models

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Project Overview

Insurance Fraud Model
Methods and Results
Discussion
Summary

Trading Model
Methods
Results and Discussion
Summary

Works Cited

Dynamo 2x2
Investigating the Impact of Honesty in Insurance and Trading Using Game Theory Models

Sissi Chen, Ruyin Hing, Chi Zhang

Project Overview

Insurance Fraud Model

Methods and Results

Discussion

Summary

Trading Model

Methods

Results and Discussion

Summary

Works Cited

Dynamo 2x2

Nonideal

s = 1; p = 50s; k = 1; c = 100; delta = 10s
Investigating the Impact of Honesty in Insurance and Trading Using Game Theory Models

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Project Overview

Insurance Fraud Model

Methods and Results
Discussion
Summary

Trading Model

Methods
Results and Discussion
Summary

Works Cited

Dynamo 2x2

Ideal

s = 0.3; p = 0.2s; k = 50; c = 0.3; delta = 0.07s
Nash Equilibrium with Change in S

Insurance company not carrying out investigation

Policyholder committing fraud
Nash Equilibrium with Change in P

Insurance company not carrying out investigation

Policyholder committing fraud

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2 Insurance Fraud Model
   Methods and Results
   Discussion
   Summary

3 Trading Model
   Methods
   Results and Discussion
   Summary

Works Cited
Investigating the Impact of Honesty in Insurance and Trading Using Game Theory Models

Sissi Chen, Ru Yin Hing, Chi Zhang

Project Overview

Insurance Fraud Model

Methods and Results

Discussion

Summary

Trading Model

Methods

Results and Discussion

Summary

Works Cited

Summary

- Dishonesty tend to happen when the claim amount is small
- With the model, insurance companies can change the relevant parameters to minimize loss from insurance fraud
Investigating the Impact of Honesty in Insurance and Trading Using Game Theory Models

Sissi Chen, Ru Yin Hing, Chi Zhang

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   Methods and Results
   Discussion
   Summary

3. Trading Model
   Methods
   Results and Discussion
   Summary

Works Cited
Basic Trust Game

Investor decides whether or not to invest

- \( -c \)

Investee decides whether or not to pay back any amount to the investor

\( cr \)

Fu, Feng
Overview and Introduction to Behavioral Analytics.
MATH 76 Lecture, 2018.
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Project Overview

Insurance Fraud Model

Methods and Results

Discussion

Summary

Trading Model

Methods

Results and Discussion

Summary

Works Cited

Model and Game Rules

Players

Investor decides whether or not to invest and the amount to invest in each investee

Each investee decides the percentage of revenue generated that they want to return
Model and Game Rules

Notations

- Wealth generating ability: fixed for each investee
- Flexibility: fixed for each investee
- Honesty: adjusted after every round based on investee behavior in the previous round
- Investor bank account: result
- Investee bank account: result
Model and Game Rules
Rules for Assigning Honesty Scores

• Each investee starts with a perfect honesty score
• If an investee chooses to be honest and returns promised percentage, their honesty score is not affected
• If an investee chooses to be dishonest and returns less than promised percentage, their honesty score decreases based on amount of dishonesty
Model and Game Rules

Investor’s Rules for Investment

- After every round, the investor ranks investees based on the amount investees return.
- The higher ranked investees, who return more to the investor, receive more investment from the investor in the next round.
- If an investee has low honesty score, the investor can choose to decrease the investment amount or not invest, based on how low the honesty score is.
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Model and Game Rules

Investees’ Rules for Changing Strategies

- After every round, each investee decides whether they want to copy the winning strategy from the last round
- Investees with higher flexibility scores copy the winning strategy more often than those with lower flexibility scores
When every investee is at least slightly flexible...

After 9 rounds, every investee decides to be dishonest.
When every investee is at least slightly flexible...

After 22 rounds, the game cannot go on anymore.

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Methods and Results
Discussion
Summary

Trading Model
Methods
Results and Discussion
Summary

Works Cited
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When inflexible investees are present...

After 9 rounds, every flexible investee decides to be dishonest

Investee profit over time

flexible winner, higher wealth generating ability

inflexible winner, higher wealth generating ability
When inflexible investees are present...

After 11 rounds, flexible investees start to be honest again.

**Investee profit over time**

inflexible winner, higher wealth generating ability

flexible winner, higher wealth generating ability
When inflexible investees are present...

After 20 rounds, all investees go back to being honest and stay honest.

Investor profit over time

- **Inflexible winner, higher wealth generating ability**
- **Inflexible runner up, lower wealth generating ability**
- **Flexible winner, higher wealth generating ability**
When inflexible investees are present...

After 22 rounds, the game is still going on

Investee profit over time

inflexible winner, higher wealth generating ability

inflexible runner up, lower wealth generating ability

flexible winner, higher wealth generating ability
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Insurance Fraud Model
  Methods and Results
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Trading Model
  Methods
  Results and Discussion
  Summary

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• Honesty is essential for the success of a society
• In the short term, dishonesty may result in more profit
• However, in the long term, honesty is important, sometimes more important than wealth generating ability, to stay successful in the competition
Future Studies

- Build honesty bots that stays perfectly honest all the time to enforce honesty in the society
- Combine the trading model with the insurance fraud model to find out how a credit system may affect the dynamics of the insurance fraud model
We would like to thank those who helped us

- Dr. Feng Fu
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- Tracy Moloney
- Fellow REU students
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  - Adam Baldoni
  - Mariah Boudreau
  - Javier Salazar
  - Carley Walker

Acknowledgements
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Investopedia, 2018.

Myerson, Roger B.
Game Theory: Analysis of Conflict.

Nowak, M. A; Coakley, Sarah
Evolution, games, and God : the principle of cooperation.
Investigating the Impact of Honesty in Insurance and Trading Using Game Theory Models

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Project Overview

Insurance Fraud Model

Methods and Results

Discussion

Summary

Trading Model

Methods

Results and Discussion

Summary

Works Cited

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Insurance Information Institute, November 6, 2017.

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By the numbers: fraud statistics.
Coalition Against Insurance Fraud, 2018.

Staff Writer
What is 'Insurance'.
Investopedia, 2018.

Staff Writer
10 Most Common Types of Insurance Fraud.
Business Insurance Quotes, 2011.

Unknown
Bimatrix Games.
Assumptions

- Single shot game for two players, the insurance company (IN) and the policyholder (PH)
- Construct the payoff matrix from PH perspective
- IN carries out basic investigations for every claim with negligible cost before secondary investigations
- IN will and only will realize fraud of PH by carrying out secondary deep investigations
- PH profit is 0 if they only receive honest claim amount
- All profits and costs can be converted to the same unit (USD)
The study of Mathematical models of conflict and cooperation between intelligent rational decision-makers.

Myerson, Roger B.
Game Theory: Analysis of Conflict.
The values of payoff functions can be described by a bimatrix:

<table>
<thead>
<tr>
<th>Player 1</th>
<th>$s_1$</th>
<th>$(a_{11}, b_{11})$</th>
<th>$(a_{12}, b_{12})$</th>
<th>$\ldots$</th>
<th>$(a_{1n}, b_{1n})$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$s_2$</td>
<td>$(a_{21}, b_{21})$</td>
<td>$(a_{22}, b_{22})$</td>
<td>$\ldots$</td>
<td>$(a_{2n}, b_{2n})$</td>
<td></td>
</tr>
<tr>
<td>$\vdots$</td>
<td>$\vdots$</td>
<td>$\vdots$</td>
<td>$\ddots$</td>
<td>$\vdots$</td>
<td></td>
</tr>
<tr>
<td>$s_m$</td>
<td>$(a_{m1}, b_{m1})$</td>
<td>$(a_{m2}, b_{m2})$</td>
<td>$\ldots$</td>
<td>$(a_{mn}, b_{mn})$</td>
<td></td>
</tr>
</tbody>
</table>

The values of payoff functions can be given separately for particular players:

$$A = \begin{pmatrix}
    a_{11} & a_{12} & \cdots & a_{1n} \\
    a_{21} & a_{22} & \cdots & a_{2n} \\
    \vdots & \vdots & \ddots & \vdots \\
    a_{m1} & a_{m2} & \cdots & a_{mn}
\end{pmatrix}, \quad B = \begin{pmatrix}
    b_{11} & b_{12} & \cdots & b_{1n} \\
    b_{21} & b_{22} & \cdots & b_{2n} \\
    \vdots & \vdots & \ddots & \vdots \\
    b_{m1} & b_{m2} & \cdots & b_{mn}
\end{pmatrix}.$$