

How Insurance Substitutes for Regulation

Through private contracting, insurers monitor safety in ways that government can't.

BY OMRI BEN-SHAHAR AND KYLE D. LOGUE

Legal regulation of behavior requires information. Acquiring information about the regulated party's conduct, setting benchmarks by which that conduct is measured, and establishing the correct scale of payoffs for violating or following regulation are costly and require expertise and motivation. Thus, economic theories of rulemaking are often based on the relative information advantages that different regulatory bodies have and how that information can be harnessed to enhance incentives and thereby improve welfare.

Government regulators, on average, do not have informational advantages. They are not paid for performance and thus may lack adequate incentives. They are not disciplined by market forces and are only imperfectly disciplined by career concerns or by the political process. Moreover, they commonly lack the most advanced tools for information acquisition, aggregation, and prediction. Courts, for example, do not search for information independently, but instead receive only what parties present to them through the litigation process, which is costly, ad hoc, and as a result often bypassed by crude settlements. Courts are also ill-equipped to recognize the distribution of characteristics from which any given case is sampled.

Government agencies, too, have limited resources to monitor

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or anticipate patterns in the behavior of sophisticated industries, often inspecting only a small sample of the regulated conduct. They may be plagued by internal principal-agent problems and they are often outpaced and outsmarted by the regulated parties. Can anyone regulate risky behavior better than the government?

Private insurance companies can, and already do, replace or augment the standard-setting and safety-monitoring currently performed by government. And they do so in ways that may increase overall social welfare.

To those readers trained in economics, this claim would seem counterintuitive. In much of the economic literature, insurance is seen as antithetical to risk reduction. Indeed, one of the cornerstones of the economics of information is the moral hazard problem: the idea that a party who is insured against risk has suboptimal incentive to reduce it. As Joseph Stiglitz explained in his 1983 paper "Risk, Incentives, and Insurance: The Pure Theory of Moral Hazard," "the more and better insurance that is provided against some contingency, the less incentive individuals have to avoid the insured event, because the less they bear the consequences of their actions." Judge Frank Easterbrook concurred: "Insurance creates moral hazard: when someone else pays the tab, the insured will take additional risks and may incur costs deliberately" (*Burden-Meeks v. Welch*, 319 F.3d 897 (2003)).

We argue that insurance can reduce and in some cases solve, rather than create or exacerbate, moral hazard and related incentive problems. When people create risk to others (or themselves), insurance is the mechanism that converts the concern about the loss or the vague threat of liability into a concrete set of harm-



reducing measures. It supplies both the incentive and the know-how that individuals and firms often lack, resulting in a more efficient level of accidents.

We contend that private insurance markets can and sometimes do outperform the government in regulating conduct because of both superior information and competition. Insurers who can offer more coverage at lower premiums will attract customers, even when they require their customers to modify their conduct in a costly way. As long as the standards imposed by the

insurers are efficient, customers should be lured by the discounts. Moreover, insurers' concern with affordability—increasing the pool of its clientele—is another force pushing for increased conduct regulation. Safe behavior by insureds reduces the cost of premiums and increases the size of the insurers' market.

How Insurers Regulate Safety

Information is critical to the business of insurance. Insurers use

information in performing their risk-spreading and risk-shifting functions. Information is necessary in pricing policies, assembling insurance pools, and verifying claims. Actuarialism—the basic methodology in insurance—is the skill of computing premiums according to information about probabilities and harms.

Insurers also use information in a subtler and less familiar way: to induce efficient risk-reducing behavior. The same data that go into the risk-spreading and risk-shifting computations are relevant and informative in determining how to reduce risk. Insurers, therefore, perform the additional information-heavy function of identifying and administering a system of safety improvements. We view this function as a form of privatized safety regulation.

Why do insurers want to reduce the risk their policyholders face? Insurance purchasers naturally gravitate to insurance policies that offer the most desirable combination of price and product (both quality and quantity). Therefore, insurers that can identify cheap risk-reduction measures can mandate them and attract more business by offering lower premiums that more than offset the cost of the mandated measures.

Another reason why insurers regulate the risk-reduction behavior of their customers is that the insurers are the ones primarily benefiting from any risk reduction that occurs after the policy is issued. Once the insured has paid the premium, any covered loss that is suffered is borne by the insurer; therefore, any loss prevented or reduced by care-level investments made by the insured is a net benefit to the insurer.

Insurers not only have the incentive, the demand, and the competitive pressure to collect and administer information about risk, they also have the tools to do so. Below, we describe the types of tools used by insurers to manage risk and incentivize risk reduction.

Ex Ante Regulation

Insurers' most basic tool for creating incentives to reduce risk is the setting of differentiated premiums. Insurers charge lower premiums to careful policyholders, those that can prove they take effective measures to reduce the insured risks. To determine an insured's idiosyncratic level of care, insurers have to collect information, which they do in various ways.

First, during the underwriting process, insurers often require their insureds to fill out lengthy insurance applications that provide the insurer with detailed information about their idiosyncratic risk characteristics. The credibility of the information acquired during the underwriting is bolstered by the use of verification methods, such as health screening tests for life insurance applicants or site surveys for environmental liability insurance. The credibility of the underwriting process is also protected by

stiff sanctions on insureds that misrepresent information.

Second, insurers cooperate to pool and analyze risk-related information through various industry-owned insurance rating bureaus. These shared data and services, which are especially valuable to the smaller insurance companies that do not have large quantities of their own data, make insurance markets more stable and competitive.

Third, while insurers often use averages in underwriting and pricing policies (that is, estimates based on average accident costs for parties that are similar to the insured), they are also able to tailor and adjust their premiums according to each policyholder's

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risk characteristics and ongoing behavior, as well as its loss experience over time. Through these insured-specific premium adjustments over time, the insured is made aware of precisely what safety investments—both care-level and activity-level—correlate with particular reductions in expected accident costs.

Differentiated insurance premiums provide explicit prices to people's choices of care in much the same way as government-set Pigouvian taxes. Thus, in contrast to traditional command-and-control rulemaking, where the agency is faced with a binary choice between whether to require a particular safety measure or not (which in turn requires the regulator to compare the benefit of that safety measure with its cost), insurers need only to price the expected risk reduction associated with the safety investment. The insureds themselves then make the choice whether that safety investment—given its costs and benefits—makes sense in their particular circumstances. Insureds for whom the cost of the safety measure is low relative to its benefits will "buy" it; others will not. This sorting avoids the inefficiency of mandated, across-the-board safety requirements.

Coaching safer conduct | A standard assumption in the insurance literature on moral hazard is that insurers have less information about policyholders' idiosyncratic care levels and risk types than the policyholders themselves have. This assumption is often contradicted by another widely held assumption about the insurance industry, that insurers have expertise in acquiring and sorting complex information. While it is true that insureds have some information that insurers cannot observe, insurers are likely to have significant advantages in understanding and calculating how different types of care and safety affect risk. While policyholders know which precautions they have taken, they often lack the expertise to quantify the effect of the pre-

caution on risk reduction, and to ascertain whether the cost of the precaution is justified. Is it worthwhile to refit one's home with fire extinguishing sprinklers? To install a car antitheft device? To take a particular medical screening test? Even commercial parties buying liability insurance may not realize how their expected cost would be reduced by taking simple precautions—until their insurer prices it.

Building on this information advantage, insurers perform a regulatory function that public regulators rarely do: they “educate” their insureds on how to avoid and reduce risks. Product liability insurers, for example, offer “product protection” plans that review the safety of product designs, the quality controls in manufacturing, and the warnings attached to the product. Similarly, workers' compensation insurers coach employers on how to refit and organize the workplace and how to train their employees, all with an eye to avoiding costly accidents. Environmental liability insurers make on-site visits and instruct policyholders on how to avoid costly damages and how to comply with (or exceed) environmental regulatory standards. Pollution insurance underwriters send engineers to the sites to examine how landfills are engineered and built and how waste is disposed, and to provide instruction where needed.

Implementing private safety codes | Insurers are instrumental in disseminating efficient safety technology. Safety measures that create positive externalities—benefits to other policyholders—would be underutilized in the absence of insurance. However, because insurance aggregates the interests of disperse policyholders, it helps to internalize such cross-insured benefits. For example, car owners can fit their cars with devices like Lojack, an antitheft transmitter that dramatically increases the chance of recovering a stolen car. Lojack creates a deterrent effect that actually benefits others and, owing to transaction costs, the Lojack purchaser cannot capture the value of this benefit through a market transaction. Thus, car owners purchase Lojack less often than is socially desirable. Insurance contracts offer a solution to this incentive problem. That is, insurers serve to collectivize the otherwise externalized benefit of the Lojack investment. Unsurprisingly, then, insurers provide substantial premium discounts—often 20 percent—to auto owners who install Lojack.

Research and development of safety methods | Insurers cooperate in identifying safety technologies and disseminating new risk reduction methods. For example, the auto insurance industry has for many years funded research designed to identify ways to reduce the losses associated with automobile accidents. The industry operates an institute that tests and rates the crashworthiness of automobiles, and it organizes concerted efforts to lobby for mandatory safety devices (such as airbags). Likewise, many of the standards relating to fire prevention and building fire codes were developed by the insurance industry and were subsequently accepted by builders, firefighters, courts, and lawmakers as the state of the art. The homeowners' insur-

ance industry has its own association researching and promulgating standards of safety with respect to property risks.

Ex Post Regulation

In addition to regulation prior to the loss, insurers also substitute for ex post regulation—the attachment of legal consequences to behavior after it has occurred. The most common form of ex post legal regulation is a court-imposed sanction.

A great body of literature explores the informational and administrative properties of ex post regulation. In this section, we are interested in identifying the informational tools that insurers have that government decisionmakers do not.

Claims management | Every insurer operates some type of claims-management system, a network of adjusters who are employed to investigate claimed losses, measure them, and negotiate payouts. Claims adjusters implement in a routine, uniform way the investigation and fact-finding procedures that are designed centrally. They apply simple rules for determination of fault and causation, for quantifying losses, and for settling disputes. This process reduces delays in payments to claimants and transforms vague safety standards issued by law into clear bright-line rules issued by insurers.

Mitigation of loss | Another way in which insurers regulate losses ex post is by helping to mitigate covered losses. This can be seen clearly in contractual provisions, found in most insurance policies, that require insureds to take all reasonable post-accident steps to mitigate losses or else forfeit coverage. Insurers also help insureds mitigate losses by monitoring repair services. The most ubiquitous example of this occurs in the automobile insurance context. Auto insurers often exercise strict control over the choice of companies to do the repairs. Environmental insurers also maintain control over the choice of contractors that insureds can hire to do the remediation or clean-up costs covered under environmental liability policies. By getting directly involved in this way, insurers both reduce the magnitude and gain an accurate estimate of the insured loss.

In addition, liability insurers help to control overall litigation costs ex post through their role as the financier of their insureds' legal defense. Liability insurance policies generally assign to insurers the contractual obligation and responsibility to provide a legal defense for their insureds. As a result, liability insurers have experience and expertise in selecting defense counsel and managing litigation expenditures, resulting in lower overall costs. Although this arrangement, where the insurer is both on the hook for loss claims (within the policy limits) and in charge of the litigation, can pose some conflicts of interests, it nevertheless leads to reasonably low-cost resolution of legal disputes for the vast majority of liability insureds. More fundamentally, the role of insurers in litigation and settlement often overrides the effect of substantive compensation doctrines. For example, insurance policy limits, not legal remedies, are found to dictate the settlement amount.

Ex post underwriting | Another type of ex post regulation by insurers, which has come under criticism from some commentators, consists of refusal to pay out claims based on policies that were issued after the insured materially misrepresented some information at the underwriting phase. The efficient functioning of insurance markets depends on insurers' ability to gather accurate information about insurance applicants.

To achieve this end, insurers have two general strategies: They can spend resources at the underwriting stage to investigate and verify the information given by insureds on their applications; and some of this they do. But exhaustive ex ante information verification can be very costly. A cheaper alternative is for the insurers to accept as true the answers given by the insureds on their applications when submitted (unless there is a red flag on the application that suggests further investigation is warranted), but then to examine more closely only the applications of the small subset of insureds that end up submitting a loss claim. Under this approach, only a fraction of the applications need to be thoroughly investigated. If a material falsehood is then found, and if it can be shown that the insurer relied upon that falsehood in issuing

or pricing the policy, the insurer can then rescind the policy and deny the insured's claim. The effect of this ex post denial of the claim is to improve the ex ante incentives of insureds to provide truthful information at the underwriting stage, and to do so at considerably lower cost than would be the case with exhaustive ex ante investigations by the insurer of every single insured.

While there is a risk of insurer opportunism (for example, insurers asking intentionally vague questions on the applications to create the opportunity for a misrepresentation defense ex post) and innocent mistakes by consumers can occur during the application process, those concerns can be addressed through common law doctrines, and bad faith sanctions can be imposed on the worst-offending insurers when appropriate.

Examples of Insurers as Safety Regulators

Agencies such as the Consumer Product Safety Commission (CPSC), the Food and Drug Administration, and the National Highway Traffic Safety Administration (NHTSA) regulate the safety of products and product use. In addition to such ex ante agency-based government regulation, product safety is also regulated ex post through the application of tort law by courts. Choosing the ideal regulatory role of these two institutions—agencies versus courts—is a familiar dilemma. But it cannot be adequately resolved without an account of how insurance arrangements support (either replace or complement) the regulatory function of tort and agency law.

The choice of a liability standard affects the type of insurance

that would complement it as a regulator of risk. For example, under a tort regime of no liability for product-caused harms (for example, the old regime under which courts enforced product-warranty disclaimers for personal injuries caused by product accidents), the primary government regulator of product safety will be command-and-control government agencies and the primary insurer-regulator will be first-party health insurers. By contrast, under a tort regime of strict products liability, the primary government regulator will be the courts and the primary insurer-regulator will be liability insurance companies. Thus the choice between no liability and strict liability turns largely on the question of which type of insurance—first-party health, disability, and life insurance or third-party liability insurance—is better at reducing product-related accidents.

The choice seems pretty clear. First-party insurers are poorly

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equipped, and liability insurers are relatively well equipped, to regulate consumer product risks. There is little that first-party insurers can do to regulate consumer product-injury risks. Health, disability, and life insurers who would pay for harms caused to consumers by dangerous products under a no-liability regime do not ordinarily distinguish between, and charge different premiums to, consumers who purchase relatively safe products and those who purchase relatively dangerous products. They do not monitor which products their policyholders purchase, how safely they use those products (care-level concerns), or how often they use those products (activity-level concerns). Nor do first-party insurers deny claims on the grounds that the insured was contributorily negligent or assumed the risk. (One exception is life insurance monitoring of cigarette smoking.) In fact, first-party insurance is often sold on a group basis, which means that insurers do not gather detailed information about any individual risk characteristic of their insureds, including those related to product use. And even in policies that are individually underwritten, it is usually too costly for insurers to gather and update product-use information. The result of this dearth of first-party regulatory intervention is moral hazard with respect to consumer care and activity levels.

Can product liability insurers do better than first-party insurers at regulating product injury risk? Product liability insurance is underwritten on a company-specific basis rather than a group basis. Product liability insurers have much at stake in the actuarial experience of each of their insured manufacturers, and so they collect detailed information about how the product is designed,

inspected, and manufactured; what types of quality controls and manufacturing standards the insureds have in place; whether parts used in the production process contain dangerous inputs and whether those parts are warranted by suppliers; and much more. Product liability insurers also collect information about the insured manufacturers' activity levels (i.e., sales volume) with respect to particular product lines and about past marketing incidents. Liability insurers are clearly more effective than first-party insurers at monitoring and regulating the safety of consumer products, hence the case for strict product liability as a form of product safety regulation—in contrast to a rule of no liability or even fault-based liability—is strengthened.

Workers' compensation insurance | Workplace safety is another area of regulation through insurance in which insurers play a major role in implementing and monitoring safety. Workers' compensation regimes, which have been adopted in all 50 states, constitute a form of no-fault strict liability. States require employers to purchase insurance either from a private insurer or from a state-run workers' compensation fund. Workers who are injured on the job recover from their employer's workers' compensation insurer. In managing claims, insurers collect information concerning the circumstances that gave rise to the injury and examine the medical records documenting the injury. As already mentioned, workers' compensation insurance is one of the areas in which insurers experience-rate premiums and have done so for many years, and the process is facilitated by various industry organizations that aid in the collection and analysis of data.

Workers' compensation regimes reduce worker-injury rates more effectively than fault-based tort regimes and direct government regulation of workplace safety. Indeed, there is some direct evidence that experience-rating by workers' compensation insurers has improved workplace safety, especially among larger firms where most individual workers are employed.

Auto insurance | The regulation of automobile driver safety is divided between first-party and liability insurers. Some, but not all, losses are shifted from victims and their first-party insurers to drivers and their liability insurers. States vary with respect to the amount of loss shifting they do through their tort systems. Most states have a tort-based auto insurance regime in which victims can recover from negligent drivers and their liability insurers, or otherwise turn to their own first-party insurers. In those states, both first-party and liability auto insurers have an incentive to regulate the care levels of their insureds. In contrast, a minority of states have some type of no-fault regime (a misnomer, which really means no-liability) in which tort recovery is limited and injured parties (other than pedestrians, whose tort claims are not limited) must rely primarily on their first-party auto insurers. In these states, therefore, first-party auto insurers are the primary regulators of driver care levels.

The shift to no-fault in some jurisdictions may on balance hinder the regulatory role of insurance. On the one hand, the

absence of tort liability, and thus of liability insurers, does not eliminate the incentives of drivers to avoid accidents that harm others. There is, after all, a large overlap between the risks that lead to harm to others and the risks that lead to injury to oneself. Bad or excessive driving gives rise to an increased risk of both harms. Thus, when a first-party insurer takes steps to regulate driver conduct so as to reduce self-harm (for example, by experience rating and adjusting premiums), the risk to third-party victims is also reduced.

On the other hand, first-party auto insurers do not have an incentive to regulate driver decisions optimally. While it is true that the safety they regulate affects both the insured drivers and their victims, the insurers fail to take account of harm to others. Thus, in theory, auto first-party insurers would not have an incentive to require precautions that could be justified only by the total harm reduction to all potential injured parties. Those insurers do not make premium adjustments to account for the increase or decrease in risk to third-parties attributable to their insured driver's behavior.

By contrast, under a fault-based tort regime in which drivers also purchase liability insurance, a more complete internalization of auto accident risks is achieved. As a result, under a fault-based regime, some unsafe drivers would be priced out of driving—a form of continually adjusting Pigouvian taxation through the liability insurance premium—which would not occur under a no-fault regime.

In addition, under a fault-based system, drivers' choices among types of cars are likely to be more efficient. First-party insurance creates incentives to purchase large and heavy vehicles, such as outsized sport-utility vehicles (SUVs) or trucks, in which drivers are protected and their injuries are smaller. Liability insurance offsets these distorted incentives. Heavy vehicles cause greater harm to others, and these costs in fault-based states are borne by liability insurers, who then price those risks accordingly. The result, in theory, should be not only a reduction in overall auto accident risks, but also an improvement in the market signals sent to product manufacturers regarding the relative total costs (including accident costs) of small versus large vehicles.

Auto insurance is also an area where insurance companies—liability and first-party insurers—work cooperatively to gather information that enhances the market for safety. For example, the Insurance Institute for Highway Safety (IIHS), a nonprofit organization that is wholly funded by the auto insurance industry and whose stated goal is to reduce the losses from crashes on the nation's highways, has become famous for testing and rating the crashworthiness of new automobiles that come on the market, and it does so long before—and arguable better than—the government's NHTSA ratings. These ratings help consumers choose safer cars and induce manufacturers to improve the designs.

Homeowners' insurance | Residential property risk is another area in which insurers regulate insured behavior. Most homeowners cannot ascertain the quality of the structure they are purchasing or the risks associated with inferior construction,

especially under conditions of high winds, fire, or earthquake. And yet, except to the extent the CPSC regulates household products, household risk is largely unregulated by the federal government. Rather, building safety standards are left to state and local governments, which typically adopt some version of the model building codes written by private organizations. Political pressures by the construction industry and short-term financial interests of homeowners operate to inhibit optimal standards and rigorous enforcement.

Insurance helps to remedy this regulatory inefficiency. First, homeowners' insurers engage in direct ex ante regulation through the use of premium discounts for homes equipped with safety measures, such as smoke detectors and sprinkler systems, that have been found to dramatically reduce the risk of fire-related deaths and property damage. Similarly, insurers in Florida and other parts of the country subject to windstorms offer substantial premium discounts to homeowners who make special investments in wind mitigation, such as installing hurricane clips to secure the roof, anchoring the base of the home to the foundation, and using special storm shutters on the windows.

Homeowners' insurers also do something that government regulators do not: generate large amounts of risk-related information through large-scale hazard simulations. The industry is funding a massive research facility for simulating hurricanes and other perils and studying how different construction techniques withstand wind, fire, water, and hailstorm damage. Research conducted at this facility is intended to do for home construction standards what the crash testing conducted by the IIHS has done for crashworthiness in automobiles, thereby reducing the losses from natural hazards. Not only will this enable the industry to improve its rating of building codes, it will also refine the premium discounts for various safety investments.

In each of these areas—product liability insurance, workers' compensation insurance, automobile insurance, and homeowners' insurance—insurers already serve as quasi-private regulators of risk. Because of their superior access to information and their commercial sophistication, and because of the competitive pressure to find new ways to lower their costs and hence their prices, insurance companies employ a variety of strategies to improve the safety conduct of their policyholders. In many of these examples, the presence of insurance reduces, rather than creates, a moral hazard problem.

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Insurance Versus Government Regulation

For many, risk insurers generally work alongside the government to regulate safety. In those areas, we identify how the regulatory work is divided between the insurers and government regulators and document the added value of insurance—incremental improvements in safety that go beyond what the government requires or encourages.

Mandates versus menus | Government regulation of safety often takes the form of mandatory safety standards. Cars must

have passive restraints, factories must abide by environmental standards, drug companies must demonstrate the safety and efficacy of a drug, and commercial buildings must have fire sprinkler systems. Unless the regulatory safety threshold is met, the actor cannot engage in the regulated conduct. Regulated parties have no choice concerning how much of the safety measure to apply, whether it is worth the cost, or if other methods work better for them.

Insurers, on the other hand, often regulate the same conduct while offering a menu of safety choices and corresponding prices. Drivers who fail to wear seatbelts have their first-party insurance premiums adjusted through experience rating. Factories that maintain higher environmental standards than the government-mandated level have their liability insurance premiums reduced. Manufacturers that follow guidelines for producing safer products pay lower product liability insurance premiums. And homes that present higher fire hazards pay significantly higher property insurance. Largely through ex ante premium adjustments, by offering policyholders clear pecuniary tradeoffs, insurers induce actors to self-select safety. Unlike government regulation, which institutes uniform safety levels, insurers' regulation results in a spectrum of decentralized choices whereby people choose greater precautions when their costs are lower or when the risks they reduce are greater.

Pigouvian taxes | In the presence of government-imposed strict liability, insurance converts the ex-post liability cost into an ex ante fee, the insurance premium. This fee resembles a pure Pigouvian tax, paid upfront and roughly equal to the externality. Risk-differentiated premiums cause parties to pay the expected external cost of their activity when choosing its scope. Insurers thus play an important role in shaping levels of activity. By converting the uncertain expected cost of liability into a certain cost of the insurance premium, premiums enable insureds to make more-informed choices regarding activity levels.

To be sure, government agencies can also engage in information gathering. But unlike with insurers, the information practices of government agencies do not have to be accurate for the agencies to perform their primary tasks because the agencies are not themselves insuring the externality. Thus, they do not have to bear the costs of the harm from imperfect tailoring. By contrast, insurers who set inaccurate premiums (inaccurate Pigouvian taxes, as it were) would suffer a loss of profit and, at the limit, would be out of business.

Converting standards into rules | Insurance arrangements transform the standards enacted through government regulation into bright-line rules, thereby providing regulated parties (insureds) with concrete instruction regarding the choice of appropriate care levels. Negligence regimes in tort law, for example, set general "due care" standards; however, the determination of which particular safety measures are required by such standards is often left unclear to the regulated parties until a court resolves that question in particular cases ex post.

Under such negligence regimes, liability insurers are often the agents that translate the vague legal standards into a set of concrete, sometimes-very-specific rules. A similar mechanism also operates under strict liability regimes, which do not mandate particular safety standards, but leave the regulated parties to determine the privately desirable risk-reduction measures. Under those regimes as well, it is often the liability insurer who instructs the regulated party regarding specific safety choices.

A prominent example of this collaboration between the standard-setting public regulators and standard-deciphering insurers is traffic safety. Tort law and highway safety regulations establish a framework for determining reasonable care and accident liability. But it is the insurance process that often establishes which actor is responsible for the accident, based on “mechanical and superficial formulas.” Because insurers have to follow routines, because they have to constrain the discretion that low-level adjusters

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For over 50 years, the auto insurance industry has published well-known car safety ratings that are often more stringent and cover more safety factors than NHTSA’s.

exercise, and because basic principles of fault and negligence are difficult to apply, insurers turn to “mechanical presumptions” such as presumed liability for the negligent drivers in rear-end collisions or for drivers turning left in front of oncoming traffic. The pressure to run an efficient claims bureaucracy and to “close cases” generates greater reliance on simple rules than the background legal system provides.

Stricter codes of safety | Another function that insurers perform is the design of safety mandates that exceed the government-regulated “floor.” Take building codes, for example. Although municipalities vary in the level of safety investments that they require in residential and commercial buildings, they are often quite lenient. While it is true that electrical wiring is inspected for safety and commercial buildings must meet fire safety and emergency standards, many of the safety-related elements of the design and construction process are left unregulated. Property insurers step in and incentivize—and sometimes even require—adherence to stricter safety standards. Similarly, environmental regulations set various standards relating to environmental exposures and harms. Environmental liability insurers complement this regulatory floor by requiring their insureds to comply with stricter codes written by private groups. They go beyond minimal compliance checks by promoting, through discounts and mandates, participation in private Environmental Management Systems that follow strict codes of environmental compliance.

Disseminating information | Like the insurance industry, government agencies gather and use information as a basic tool in regulating safety. For example, NHTSA collects accident reports from traffic law enforcers around the country, as do insurers. The FDA collects information about drugs; the CPSC collects information about risky products; the Environmental Protection Agency collects information about the release of hazardous substances; and municipalities collect information about restaurants’ hygiene.

Like insurers, the government disseminates this information about risk to help people make informed decisions. Thus, NHTSA publishes SUV rollover ratings as well as many other auto safety facts. But safety ratings were prominently available long before NHTSA began publishing SUV rollover ratings. For over 50 years, the auto insurance industry has published well-known car safety ratings that are often more stringent and cover

more safety factors than NHTSA’s. For example, the insurance industry’s four-grade scale includes many safety attributes that go beyond rollover risk. It takes into account a car’s roof strength and how much protection it provides in the event of a rollover. Experts can debate whether the insurance ratings capture a more or less impor-

tant set of factors than the government’s ratings, but it is likely that the more robust the ratings that insurers produce, the less necessary is the government’s scheme. Given the comprehensive data insurers have and their incentive to rate cars credibly, this particular safety-related exercise can probably be largely outsourced to the insurance industry.

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Expanding the Role of Insurance

Can private insurance markets supplement or even replace regulation in some settings? Below are some suggestions for doing so.

Consumer contracts | Consumers require protection because they sometimes agree to bad terms in their contracts, not understanding in advance what they have agreed to. Consumers also require protection because the promises that are made to them are sometimes broken: for example, products are not as described, merchandise is not delivered, money is excessively charged. When these breaches occur, contract law provides remedies, but enforcement is costly and largely impractical. Individual consumers cannot credibly threaten to sue; as a result, businesses are undeterred.

Class actions are one way to deal with this under-enforcement problem, but impediments to such actions abound. Some claims are not aggregable into representative classes; some contracts waive class-action rights; and attorney-fee arrangements sometimes

produce an imperfect selection of cases. The universe of contract claims that are too small or too complex to pursue individually in litigation is vast. Often obscured by lengthy standard forms, consumers cannot distinguish their rights, cannot adequately seek redress, and have to rely on nonlegal mechanisms (e.g., sellers' ratings, retailer return policies) to steer clear of the risk of loss.

Do first-party insurance arrangements relieve some of the insecurity that consumers, deprived of de facto contractual remedies, experience in these contexts? And could such insurance actually provide businesses with incentives to perform their promises?

Pockets of explicit first-party consumer-protection insurance already exist, and it is not difficult to see why. Consider, for example, individuals who purchase cars on eBay Motors. In that market, consumers send money to sellers who often do not have a brick-and-mortar location, have undeveloped reputations and limited assets, and who, for all of these reasons, might easily take

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The market-makers, retailers, and payment intermediaries sometimes step in and offer bonds, guarantee programs, or recovery funds to induce buyers to enter their network.

the money and run. Yes, buyers have legal remedies when eBay sellers breach their agreements, but the enforcement of such remedies is unlikely.

Perhaps in response to this legal-remedial void, eBay Motors itself provides a number of options for insuring car buyers against the risk of non- or underperformance by car sellers. For example, eBay Motors provides disappointed buyers a fund from which they can recover the lost payment if the seller defrauds them, up to \$50,000. Similarly, online purchasers of consumer electronics can use a service like SquareTrade to buy what amounts to first-party insurance against the types of risks that contractual seller-provided warranties would usually cover. Credit card issuers often provide similar "purchase protection" to buyers of consumer products who use the issuer's credit card as the form of payment. PayPal likewise offers a "Buyer Protection Plan" that reimburses buyers for the full price and shipping costs if their complaint against the seller is found to be meritorious. In all of these cases where there is a risk of the seller taking the money and running, the market makers, retailers, and payment intermediaries sometimes step in to offer bonds (or guarantee programs or recovery funds) to induce buyers to enter their network.

Perhaps less obvious, this new type of first-party consumer transaction insurance could also deter opportunism on the part of businesses that sell to consumers. For example, through various information aggregation techniques, insurers might be able to identify sellers who engage systematically in opportunistic

or otherwise wrongful behavior and, in effect, "blacklist" them. Sellers that are repeat offenders could be singled out by insurers and classified as bad risks. Insurers could, in turn, warn insured consumers not to purchase from these high-risk sellers and could in extreme cases exclude coverage for claims arising out of sales involving the worst-offending sellers. Exclusions that say such things as, "This policy does not cover purchases from Seller X," would serve the ex ante regulatory role of increasing the salience of those companies' nonperformance risk, deterring misconduct.

Market-making insurers can even charge businesses for coverage. For example, eBay Motors provides an insurance-like buyer protection program without charging buyers any premium. Instead, it charges sellers for the cost of the program, and it can differentiate the price according to the seller's record and expel sellers who breach their obligations.

Why is such an insurance product not already offered broadly?

We noted that miscellaneous first-party consumer insurance pockets exist through the efforts of market makers, payment systems, and warranty programs—all in areas in which the liability system is ineffective in shifting the costs to the wrongdoers. But the full-blown information tools of the insurance industry have not been harnessed to this end, perhaps because the demand for such

coverage is already filled by the niche assurance products. What seems more likely, however, is that, until recently, it was assumed by insurers that the demand for coverage against the risks of consumer product under- or nonperformance was met by the product sellers themselves through the sale of product warranties. It is also possible that the trend in American law of businesses using mandatory arbitration clauses to immunize themselves against court-imposed liability for breach of consumer product contracts may dramatically increase the demand for first-party insurance coverage as a substitute for legal control of consumer product quality.

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Conclusion

Insurers regulate risk in various ways. From mandating specific investments in risk reduction, to offering premium discounts for favorable claims experience, to selling cost-containment expertise to policyholders, and even to the design of safety technologies and codes, insurers perform many of the same regulatory functions that government regulators and courts perform. However, in many (though obviously not all) situations, private insurers, because of their inherent informational comparative advantage, should be expected to do the job of regulation better than public regulators and courts. Through private contracting, insurers monitor safety in ways that legal commands cannot. **R**