**‘Regulation’ by Insurance**

Kenneth S. Abraham[[1]](#footnote-1)\*

1. I'm delighted to be at a meeting of BILA in person. I joined BILA during the pandemic and have watched at least a dozen presentations through the magic of Zoom. And I have been impressed – flabbergasted is a more nearly accurate term – by the attendance you get online. There is nothing quite equivalent in the US, although there must be many more insurance lawyers in the states. So bravo all around to BILA, which I understand is having its sixtieth anniversary celebration tonight. And it’s wonderful to be in this elegant and historic room, the Old Library at Lloyds.
2. I am mindful that I am an academic talking to a group that is composed mainly of practicing lawyers. Therefore I am not going to talk about ‘theory,’ though I am fond of quoting Justice Holmes, who said that ‘even for practical purposes theory generally turns out’ to be ‘the most important thing in the end’. [[2]](#footnote-2)
3. My talk is not theory, but neither is it directly practice-oriented. Rather, I would describe my subject, Regulation by Insurance, as an exercise in interpretation. Not interpretation of particular insurance policy provisions, but interpretation of the function and purposes of a group of related insurance policy provisions and practices, and a critique of how some people describe them.
4. Some of my interpretations may be obvious, some I hope will not be obvious, but my aim is to link them together in ways that have not always been completely recognized, with some of these ways also being counterintuitive.
5. The notion of insurance as a regulatory device has become a prominent trop in recent years. In the US, a leading article by insurance law Professors at the University of Chicago and the University of Michigan, entitled ‘Outsourcing Regulation: How Insurance Reduces Moral Hazard’ makes the claim that ‘in a variety of areas private insurance companies can, and already do, replace or augment the standard setting and safety monitoring currently performed by government’.[[3]](#footnote-3)
6. A quick online search for treatments of the same subject in the UK yielded the contention on the website of the BCF group, an insurance and business consultant, that ‘insurance companies are increasingly becoming active at influencing the health and safety policies of the company to which they provide insurance’.
7. And the Geneva Association, probably Europe’s leading think tank on insurance, recently produced a research report entitled ‘From Risk Transfer to Risk Prevention’, among other things touting the benefits of insurance’s ‘promoting of less risky behaviors’.[[4]](#footnote-4)
8. On the other hand, in my experience traditionally the insurance industry has taken the position that affirmatively promoting safety is not its job, and many of us have had conversations with insurance professionals who privately emphasize that point.
9. I want to examine these kinds of claims in this lecture, both analyzing and evaluating the notion of regulation by insurance. Ultimately, after leading us through what I hope is an interesting set of interpretations, I want to suggest that perhaps the notion of regulation by insurance is more misleading than helpful, and that we ought to encounter the concept with informed skepticism.

**Defining Regulation**

1. Now, I define regulation, or what might be called regulation proper, as legislative or administrative controls on civil behavior, mainly designed to promote health, safety, or welfare. That definition is probably too broad, because it could include rules about traffic safety, and too narrow, because it would be a stretch to include securities regulation in the definition, even though securities regulation, on the civil side, is undoubtedly regulation. But I ask you not to be too picky about this definition, because we all know regulation proper when we see it, and in any event my contentions do not turn on how to define regulation proper.
2. The one characteristic that all the things we would call regulation proper have in common is that they emanate from government, which has the authority to issue and apply regulatory rules and restrictions on private conduct.
3. It follows that when I refer to regulation by insurance, I am speaking figuratively, or by analogy. Insurance does not engage in de jure regulation; the question is whether and to what extent insurance nonetheless does some things that are like regulation, or have the same or similar effect as does regulation. Just as importantly, because I am far from the first person to address the subject, I contend that scholars have often exaggerated and misconceived what regulation by insurance is.[[5]](#footnote-5)
4. We should be careful to distinguish between the situations and practices in which insurance has or can have what I would call, a net-positive effect on loss and those situations in which insurance merely reduces the net-negative effect on the occurrence of loss that insurance would otherwise have. I will come back to that distinction later, identifying more precisely what could count as genuine regulation by insurance.
5. Now, we could say that sometimes insurance engages in de facto regulation. One difference between de jure regulation by government and de facto regulation by insurance is that de jure regulation – what I earlier called regulation proper – usually has the express purpose of controlling or influencing behavior. In contrast, sometimes that is the purpose of regulation by insurance, though not always. I want to set this point aside for the moment and come back to it later.
6. I divide regulation by insurance into two categories. The first I call regulation through gatekeeping. The second I call regulation through risk management.

**Gatekeeping**

1. There are activities in which it is unlawful to engage, or for practical purposes impossible to undertake, without insurance. The gatekeeping function of insurance is analogous to the licensing that governmental regulators perform. There are numerous examples. For example, you must have third party insurance to be permitted to drive – it’s typically called auto liability insurance in the US, and motor insurance or vehicle insurance in the UK. It protects you against liability in tort, and by doing so protects victims against the risk that they will have a cause of action but be unable to collect judgments.
2. The effect of this insurance requirement is to place auto insurers in the position of gatekeepers. They decide who can drive and who cannot, though of course there are some lawbreakers who drive without insurance. Driving is so essential an activity that in the US, and I assume in the UK as well, there are restrictions on the way that insurers exercise this gatekeeping function. Public regulators thus regulate the private regulators. But the insurers are certainly doing what amounts to regulation.

1. Another example is that, in the US and I would be willing to bet in the UK as well, either insurance or other proof of financial responsibility is a prerequisite to handling, transporting or storing hazardous chemicals. For small and medium size businesses, who cannot always prove financial responsibility by virtue of their limited assets, access to liability insurance is a prerequisite to doing business
2. Third, for practical purposes most people cannot buy a home without a mortgage loan, and you cannot get a mortgage loan unless you have what in the US we call Homeowners’ insurance – property insurance covering perils such as fire, wind, explosion, and so forth. Property insurers are therefore the gatekeepers to home ownership.
3. Fourth, In the US, having malpractice liability insurance is a prerequisite for any physician who wishes to practice, even in part, in a hospital or hospital-owned facility. Admitting privileges simply won’t be granted to a physician without that insurance. The result is that malpractice insurers are the gatekeepers to the right to practice medicine for the vast majority of physicians.
4. One last example. No one in their right mind would be willing to serve on the board of directors of a publicly-traded US corporation without Directors & Officers liability insurance. Suits alleging breach of the duty of care, duty of loyalty, or for making misrepresentations that violate the US securities laws, sometimes allege liability for damages in the billions, and certainly often settle for tens or hundreds of millions of dollars.
5. The corporations on which directors serve are permitted to indemnify directors’ liability *only* for certain liabilities, and in any event may be financially unable to satisfy their indemnification obligations. Only D&O insurance then stands between individual directors and financial ruin. So D&O insurers are the gatekeepers to serving on a corporate board.
6. Thus, my observation as a result of this brief analysis is that insurance gatekeeping is genuinely regulatory. This process probably creates more safety than would exist without it. It has what I call a net-positive impact on safety.

**Risk-Management Function**

1. There are more questions here about the accuracy of the notion that this is regulation by insurance.
2. Risk Management by insurance is mostly about attempting to combat moral hazard. The concept of moral hazard dates from the of the 19th century.[[6]](#footnote-6) The concept itself came to be used in addressing the phenomenon of betting on lives and property through the purchase of insurance by people who did not have what we now call an ‘insurable interest’ in the life or property insured. It can readily be seen that the phrase moral hazard is literally accurate when used to describe insuring the life or property of a stranger. The incentive to destroy the life of a stranger or property one does not own in order to recover insurance is indeed a moral hazard. Parliament enacted statutes precluding these practices, and (as just noted) the term moral hazard has been used to describe this concern.[[7]](#footnote-7)
3. But for some time now, economists, legal scholars, and practicing lawyers have used the term more broadly. Moral hazard today refers to the incentive of an insured party to exercise less care to avoid causing an insured loss than the same party would have exercised if the loss were not insured.[[8]](#footnote-8)
4. The insurance function is always potentially challenged by moral hazard understood in this broader sense. Insurers ideally want to discourage it, and then charge premiums that take into account the additional losses that the remaining, undiscouraged moral hazard, causes.
5. The four main devices that insurers use for this purpose constitute the second form of putative regulation by insurance, all falling under the general heading of risk management.
6. The first such device is risk-based pricing. At any point, a party should and usually will anticipate that premiums for the insurance the party will purchase in the future will be dependent on two factors: 1) identifiable risk-posing features of that party’s current conduct or operations, and the actual losses this party has experienced in the period prior to applying for, or renewing, the party’s insurance coverage. We can call pricing based on these factors feature-rating and experience rating.
7. Feature and experience-rating serve additional purposes other than combatting moral hazard, including limiting cross subsidization of higher-risk policyholders by lower-risk policyholders, and thereby avoiding as much adverse selection as is practical.
8. But their main function for my purposes here is creating incentives on the part of policyholders and potential policyholders to consider employing precautions that reduce the risk of loss, in order to reduce future premiums. These are only incentives to consider what to do, however.
9. It may be that, because risk-based pricing in a particular situation is not refined, or because policyholders have only imprecise information about the effect particular current precautions will have on future premiums, the incentives created by risk-based pricing are often weak.
10. That is a disadvantage of this and certain other forms of incentive-based regulation, whether regulation proper or regulation by insurance. Regulated parties have to have precise information about the impact of the behavioral choices they might make on the cost consequences of these choices, or risk-based pricing will create only vague incentives.
11. In my opinion insurers tend to do a poor job of communicating this information to policyholders. This is in part because they do not want to reveal their trade secrets, and in part because their feature and experience-rating are more crude than they want to admit.
12. With the inevitable future reliance on Artificial Intelligence (AI) by insurers to set premiums, the information may start to become more refined, but it also will start to become essentially inaccessible to insurers as well. AI won’t always explain; it will just conclude and advise.
13. A second incentive-based approach to combatting moral hazard is partial insurance, at both the low and high monetary ends of coverage. At the low end, deductibles and self-insured retentions mean that no loss is fully covered; the policyholder is a self-insurer of some loss, and therefore retains an incentive to consider reducing risk. In liability insurance, there also are monetary coverage limits at the high end, making the policyholder a self-insurer for sums in excess of the limit.
14. Typically, the policyholder gets more precise information under this approach than under risk-based pricing, because insurers may quote different premiums for different amounts of self-insurance. The disadvantage is that this approach works by reducing the amount of insurance a policyholder has.
15. The less insurance, the less moral hazard, because partial insurance is really partial non-insurance. Sixty years ago, Kenneth Arrow won a Noble Prize in economics for making a series of points turning on this one.[[9]](#footnote-9) This is obvious now, but maybe it was not so obvious then.
16. Another risk-management device has the same kind of structure. Policy provisions restricting or excluding coverage combat certain forms of potential moral hazard by denying insurance for categories of high risk. There is no coverage of liability for harm that the policyholder intended to cause; thereis no no coverage of your home if you leave it vacant for more than 60 days; there is no liability insurance coverage if the policyholder doesn’t cooperate in the insurer’s defense of a suit against it.
17. To the extent that policyholders are aware of these kinds of exclusions – sometimes a heroic assumption -- then the exclusions have the potential to combat moral hazard and therefore to function in a manner analogous to regulation. But instead of there being a governmentally-imposed fine for violation or an injunction, the policyholder foregoes insurance coverage by violating them.
18. But like partial insurance, coverage exclusions are non-insurance. They combat moral hazard by eliminating the cause of moral hazard, which may be a completely good result, as in the case of intentional-injury exclusions, or a result with mixed advantages and disadvantages, as in the cas of vacancy exclusions in property insurance. For example, such exclusions may be unavoidably overbroad, because of the impossibility of deciding after the fact how much increased risk a particular vacancy caused, or unduly costly, as in the case of a policyholder for whom keeping premises occupied may entail a high cost.
19. The last form of risk-management in which insurers engage is exactly that: direct risk management through what I call, non-technically, coaching. This may run from the general to the particular. Sending out tips about fire prevention to all policyholders is an example of the former. Inspecting a policyholder’s factory floor and providing a list of possible safety improvements is an example of the latter.
20. The particular is much more likely to have an impact than the general, but the particular is likely to be more costly for insurers than the general. Moreover, the insurer can only capture the benefits of its advice in the short term. Advice based on an insurer’s special expertise can lower risk, but the insurer cannot prevent policyholders who take the advice from later switching insurers. This prospect can inhibit giving such advice.
21. In the US, where potential tort liability sometimes seems to run wild, giving particularized advice might even risk exposing the insurer to liability for giving negligent advice, thus possibly further inhibiting the giving of particular advice. In my experience most insurers engage in comparatively little risk-management coaching, with the lion’s share of it occurring within genuinely mutual insurers such as municipal risk pools, where policyholders trust the advice because they believe, correctly or not, that it is more likely to be accurate.

**Gatekeeping and Regulation**

1. Many insurers, when asked or confronted, say that it’s not their job to promote safety or to regulate, and that the things they do that have this effect are just a product of doing business, not their purpose. I think this stance is partly the product of not wanting to be shouldered with any direct responsibility for promoting safety, and then being blamed for not doing it effectively.
2. But it’s also the result of insurers having no reason to think of themselves as performing that function, even if in fact that’s exactly what they do, without realizing it. This is a bit like the character in Moliere’s play, *The Bourgeois Gentleman*, who was surprised to learn that he had been speaking prose all his life.[[10]](#footnote-10) Insurers may be surprised to learn that they have been regulating all the time they have been in business.
3. Now I want to identify some contrasts between regulation by gatekeeping and regulation through risk management.
4. Gatekeeping is binary. You either have the requisite insurance and the gate is raised, or you don’t have the requisite insurance and you can’t get in. In contrast, three of the four risk management devices are not binary. They rely on financial incentives that leave policyholders to decide what level of risk to maintain, by comparing the cost of less risk and lower premiums with more risk and higher premiums. Of course, coverage exclusions *are* binary, in that they withhold or deny coverage of certain risks, rather than using sliding scale premiums for insuring the risk in question.
5. Further, gatekeeping is sometimes directly delegated authority to regulate. Examples include drivers’ licenses and handling hazardous chemicals, where there is a governmentally enacted requirement of insurance, with insurers doing the deciding about whether to issue the required insurance. In contrast, none of the regulation through the other various risk-management devices is directly or expressly delegated; insurers exercise their own, independent authority to employ these devices. Insurers make their own decisions about how to set premiums, word policies, and coach policyholders. The insurers are regulated in these regards, it is true, and therefore are sometimes constrained or nudged in a direction that may promote them being more, or less, involved in combatting moral hazard. But all that is pretty indirect.

**Regulation Proper and Regulation by Insurance**

1. I turn now to some contrasts between regulation proper and regulation by insurance, whether the latter is gatekeeping or risk management.
2. Regulation proper is not one thing anymore, but a variety of things: command and control mandates, pre-market licensing, Pigouvian taxation such as graduated emission or effluent charges, and technology forcing, among other things.
3. There are considerable similarities in the use of these techniques. Gatekeeping looks a lot like pre-market licensing; the use of exclusions from coverage looks something like command and control; risk-based pricing and partial insurance look a lot like Pigovian taxes; technology forcing resembles experience-rating in that both give policyholders what looks like a goal and leaves them to decide how to achieve it.
4. Clearly, regulation by insurance should not be understood as a substitute for or alternative to government regulation, but as a supplement. The reason is that the devices I’ve surveyed rarely will have a net-positive effect on loss. That is, they rarely will result in there being less loss than there would have been if there had been no insurance of the activity that caused the loss. Insurance of parties who are judgment-proof would be a possible exception. Most drivers could not pay judgments without insurance. The prospect of their insurance premiums rising *might* therefore cause them to drive more carefully than they would if they weren’t insured. Coaching by insurance might also, sometimes, have a net-positive effect on loss.
5. But aside from situations such as these, insurance creates moral hazard: it increases the risk of loss beyond what that risk would be in the absence of insurance. Virtually all the risk management devices insurers use to combat moral hazard merely reduce the increased risk of loss that results from moral hazard. These devices do not have a net-positive impact on loss; rather, they reduce the net-negative impact of insurance on loss.
6. I suppose that if we simply assume that insurance is pervasive, a constant in our lives and economy, and that therefore the increased loss that insurance generates is somehow ‘natural,’ then we could think of risk management by insurance as decreasing the natural amount of loss that occurs out there is in the world.
7. But that seems strained to me. A certain background level of risk is not inevitable or natural. It’s contingent on what insurance actually does. If I serve food to which a few people may be allergic and I keep epinephrine on hand to treat their symptoms I haven’t reduced the risk of allergic reactions, even if such reactions are in some sense inevitable. I’ve increased the risk of reactions and then mitigated them, somewhat
8. In any case, in contrast to insurance, regulation by government is always designed to have a net-positive effect on loss. In fact, given this crucial difference, I do wonder whether the figurative term ‘regulation’ by insurance is a useful conception as it applies to risk management. The conception may capture a small insight, but at the risk of creating significant misunderstanding.
9. Nonetheless, with this clarification in hand, we can identify some of the advantages and disadvantages of the two very different forms of regulation, by government and by insurance.

**Advantages of regulation by insurance**:

1. First, *Efficiency:* Government is not nimble; insurers often can move more quickly. Government is subject to stalemating by lobbying, whereas insurance is likely to be able to overcome these obstacles. Second, *Decentralization and variety.* Government regulation is more likely to be, and required to be, uniform. Different insurers can experiment with different approaches. Third, regulation by insurance is likely to be perceived as less intrusive, whether it is in fact or not.

**Disadvantages of regulation by insurance**:

1. First, Government can much more effectively protect against discrimination; indeed, it’s often required to, whereas insurers can more readily use proxies that have a discriminatory impact. Second, Government doesn’t earn profits. As a non-profit, it may cost less. Third, insurers may under-regulate, because achieving optimal safety or welfare is not the goal of insurance.

**Concluding Observations**

1. So, what lesson can we learn from all of this, apart from having a better recognition of some of the things insurance does to impact safety?
2. I would say that the lesson is that sometimes efforts to use analogy and metaphor in scholarship or legal interpretation can yield helpful or even deep insights. But doing this can also lead us astray. If what you sell – in this case insurance – creates risk, and then you fashion it so that it doesn’t create as much risk as it otherwise would, calling that ‘regulation’ is a bit odd. That’s not regulation, it’s creating danger, but less danger than would otherwise be created.
3. Note that I’m not being critical of the fact that insurance automatically creates moral hazard. In a sense the whole point of insurance is to encourage valuable, risk-creating activity. Inevitably that means that the whole point of insurance is sometimes to create more loss than would otherwise occur, in return for there being a greater quantity of valuable conduct. But we should see this positive phenomenon as clearly as we can. We should see it as a tradeoff – more valuable activity occurring in return for more loss occurring. We shouldn’t see trying to minimize the loss we do create as regulation.
4. The great analytic philosopher Ludwig Wittgenstein said that philosophical problems arise when language goes on holiday[[11]](#footnote-11). That’s true of some legal problems too.
5. In connection with the notion of regulation by insurance, that’s an imperfect description – actually, it is itself a metaphor. That is, in the case of the concept of regulation by insurance, language did not so much go on holiday. Rather, insurance was sent to the wrong work address. It was sent to the place where regulation resides, rather than to the address where loss-spreading resides.
6. It has been somewhat helpful to see what went on at that other place of work and to see how things operated there. It was interesting for insurance to visit the site of regulation. But perhaps now it’s time for our thinking about insurance to go back to the place where insurance actually does its own work. In any event, we certainly shouldn’t think that the two different addresses are actually one, or even that they are next door neighbors.
7. Thank you very much for indulging me in this inquiry. It has been a real pleasure to share my thoughts with the ancient and honorable community of insurance lawyers.

1. \* David and Mary Harrison Distinguished Professor of Law, University of Virginia School of Law. This was a BILA lunchtime lecture delivered on 16th October 2024. [↑](#footnote-ref-1)
2. Holmes, ‘The Theory of Legal Interpretation’ (1899), 12 Harv LR 417, 420. [↑](#footnote-ref-2)
3. Ben-Shahar and Logue, ‘Outsourcing Regulation: How Insurance Reduces Moral Hazard’ (2012) 111 Mich LR 197, 199. [↑](#footnote-ref-3)
4. Geneva Association, *From Risk Transfer to Risk Prevention* (May 2021) < https://www.genevaassociation.org/sites/default/files/iot\_insurance\_research\_report.pdf> [↑](#footnote-ref-4)
5. A co-author and I have extensively catalogued this literature in Abraham and Schwarcz, ‘The Limits of Regulation by Insurance’ (2022) 98 Ind LJ 215. [↑](#footnote-ref-5)
6. Tom Baker, ‘On the Genealogy of Moral Hazard’ (1996) 75 Texas LR 237, 248. [↑](#footnote-ref-6)
7. [1746] 19 Geo.2 c. 37. [1774]14 Geo. 3, c. 48. [↑](#footnote-ref-7)
8. Abraham and Schwarcz, *Insurance Law and Regulation* (West Academic, 2022, 7th edn)8. [↑](#footnote-ref-8)
9. Nobel prizes are not awarded for particular works, but one of his more famous works on the subject is K.J. Arrow, ‘Uncertainty and the Welfare Economics of Medical Care’ (1963) 53 Am. Econ. R. 941. [↑](#footnote-ref-9)
10. Jean Baptiste Moliere [1670] *The Bourgeois Gentleman*, Act 2 Scene 4, from <https://moliere-in-english.com/2007/scripts/bourgeois/index.html>. [↑](#footnote-ref-10)
11. Ludwig Wittgenstein, *Philosophical Investigations* (Blackwell, 2001) § 38. [↑](#footnote-ref-11)