Comments on
The Legal Constraint of Misrepresentation in Insurance Markets
by Shinichi Kamiya and Joan T. Schmit

Daniel Schwarcz,
University of Minnesota Law School
Overview of Paper

• Equilibrium in insurance markets depends on legal rules (!)
• Post-loss investigation → full coverage separating equilibrium, depending on
  – (i) accuracy of test, (ii) cost of test, and (iii) impact of rescission
• In equilibrium, insurers charges high premium for low-risk policy to signal intent to investigate.
  – Returns excess as rebate
• When rebate is costly, underwriting may reduce excessive premium
Great Paper

• Recognizes importance of law and regulation to results in insurance markets
  – Classic R/S model depends on deeply limited assumptions about how insurance markets operate in practice
Comment 1: No recognition of downside of post-loss underwriting

• In practice, misrepresentations and non-disclosures are often innocent.
• Very difficult to distinguish between innocent and intentional misrepresentations
• Post-loss underwriting → increased policyholder risk
Comment 2: Gap between legal rules and model

• Legal rules are complicated and variable
  – Incontestability, duty to underwriting, definition of materiality, requirement of intentionality

• All nuance and variability of rules is lost in model
  – Legal rule modeled is not rule in majority of jurisdictions
  – How might changes in legal rules impact model?
Comment 3: Why is extra premium needed to credibly signal intent to engage in rigorous post-loss review?

- In model, post-loss review for low-risk policy requires higher premium because of assumption that only premium component allocated to testing can be used for testing.

- Carriers can credibly threaten to engage in sufficient testing even if have high amount of claims.
  - Won’t need to actually engage in that amount of testing so long as threat is credible.
Comment 4: Voiding of Policy not likely to lead to complete loss of wealth

- Recovery by accident victim is endogenous to amount of collectible insurance
- Tort victims rarely pursue “blood money”
- When they do, bankruptcy often allows policyholders to shield a substantial amount of assets