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The Value of Understandable Consumer Insurance Contracts

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ABSTRACT

Insurance consumers, the intermediaries who serve them, and the regulators who protect them all would benefit from understandable consumer insurance contracts. This article outlines the benefits of understandable insurance contracts, identifies the regulatory tools that are or can be used to ensure such comprehensibility, and reviews the existing literature about how well consumers comprehend their insurance policies within the context of personal lines insurance in the U.S. The article concludes by proposing an empirical research strategy to study consumers' understanding of the terms of homeowners insurance policies and, even when they have not read their policies, their expectations about coverage.

Keywords: Insurance policy language, consumer understanding, personal lines insurance

I. Introduction

An insurance contract may be the only thing that stands between an individual who suffers a large, unexpected loss and financial ruin. But even if the individual has an insurance policy in force, whether that policy actually covers the loss depends on its precise wording. This conclusion follows from the basic principles of contract and insurance law. Nearly universally across the globe, the plain language of the insurance policy generally determines whether there is coverage, at least assuming that those terms are not ambiguous in the context of a particular claim (American Law Institute, 2019).

The contractual character of insurance policies makes it vital that ordinary consumers be able to read and under-

stand the language in those policies. Yet reading the policy makes little sense for most consumers given that insurers sell their policies on a take-it-or-leave-it basis and the terms of coverage are often—though not always—similar or identical across different insurers (Schwarcz, 2014).¹ In fact, insurance companies usually do not even give customers the insurance policy until the coverage is nearly finalized - when the transaction costs of backing out of the purchase are significant (Ayres & Schwartz, 2014). Moreover, many consumers likely assume that their insurance agent will inform them directly if their policy does not cover something “important.”

Even so, comprehensible insurance policies provide at least three essential benefits to insurance consumers. First, such policy language enhances the capacity of the small subset of individuals who do read insurance policies to understand the terms of coverage (Schwarcz, 2007).

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¹ In the United States, the homogeneity of property/casualty insurance policy terms is a byproduct of insurers' historical reliance, in part or in full, on policy forms that the Insurance Services Office (ISO) drafts and updates. The ISO is a commercial entity that provides a variety of services to the insurance industry, including policy language.

Second, understandable insurance policies allow for consumers to meaningfully assent to the policy terms even if they choose not to read that policy (Boardman, 2009). Third, insurance policy language that consumers can read and understand can promote fair and efficient claims payments when insureds suffer a loss (van Boom et al., 2016).

Thus, clear and comprehensible insurance policy language is an essential consumer protection goal in all personal lines insurance markets. Yet many informed observers have expressed skepticism about the success of legal and regulatory strategies intended to produce insurance policies that are comprehensible to ordinary consumers, or even reasonably well-trained insurance specialists (Boardman, 2006; French, 2017). However, remarkably little empirical research has examined whether strategies to produce comprehensible policy language have been effective. The limited empirical evidence that is available has mostly been conducted by industry or journalists and has focused predominantly on consumers' understanding of coverage in general, without any investigation of how this general understanding is impacted by the actual insurance policy that defines the scope of coverage (Metz, 2022; Nationwide, 2013).

This article thus aims to examine the value of comprehensible insurance policy language as a critical consumer protection goal. Section II more fully reviews the potential benefits of insurance policy language that consumers can understand. We introduce four categories of insurance consumers - coverage realists, coverage agnostics, coverage pessimists, and coverage optimists - and discuss the potential market problems associated with each category. Section III describes the various tools that law and regulation use to attempt to achieve comprehensible insurance policy language. Section IV reviews the limited empirical evidence regarding how well consumers understand the scope of their insurance coverage generally, and how well they can understand communications, including insurance policies, related to such coverage in particular. Section V describes a strategy to empirically test consumer understanding of insurance policy language and factors that influence that understanding, including whether consumers are coverage realists, agnostics, pessimists, or optimists. Section VI concludes. The focus throughout the article is personal lines homeowners' insurance policies in the U.S., though much of the discussion is applicable to other insurance policies as well as to countries across the globe.

II. The Value of Comprehensible Insurance Policies

A. Promoting Consumer Understanding of Coverage

Insurance policies that consumers can comprehend tend to promote consumer understanding of coverage for several reasons. First, while most consumers do not read their insurance policies at the time of purchase (Ayers & Schwartz, 2014; Bakos et al., 2014; Ben-Shahar & Schneider, 2014; Hillman & Rachlinski, 2002), some do. Comprehensible language should improve the understanding of what is covered and what is not for those few individuals who do take the time to read their policies. It could also increase the number of consumers who would attempt to read their policies in the first place. Second, and arguably more important, considerably more consumers will read their policies, at least the key terms in their policies, if they suffer a loss and file a claim, especially one that their insurer denies. A consumer has an obvious interest in understanding the basis for an insurer's claim denial. What is more, state law typically requires insurers to give the policyholder the precise basis for any claim denial decision, including a reference to the specific language in the policy that forms the basis for that denial (Schwarcz, 2014). In such situations, the insured is more likely to know if they have a basis to contest a denied claim if the policy language on which the insurer relies is comprehensible than if it is opaque or confusing (Boardman, 2009; van Boom et al., 2016).

Third, even if most consumers do not read their policies, others do, including market intermediaries, consumer advocates, academics, sophisticated consumers, lawyers, judges, and regulators. The more comprehensible the language is to those individuals, the better able they will be to spotlight potentially unreasonable coverage restrictions and to explain the terms of coverage to others, including to unsophisticated consumers (Schwartz & Wilde, 1983).

When consumers do not understand the language in their insurance policy, their expectations about what the policy covers are likely to diverge from reality. This can lead to a myriad of potential distortions in insurance markets, ranging from insufficient protection against risk to excessively priced coverage to increased moral hazard.²

To better appreciate the potential for these distortions,

Table 1. Categories of consumer expectations about insurance coverage

Consumer Expectations of Coverage at Purchase	Coverage Realist	Coverage Agnostic	Coverage Pessimist	Coverage Optimist
	n.a.	n.a.	n.a.	Overpricing Risk
	n.a.	n.a.	Moral Hazard Risk	Moral Hazard Risk
Potential Market Problems Associated with Coverage Expectations	n.a.	Restrictive Policy Terms Risk	Restrictive Policy Terms Risk	Restrictive Policy Terms Risk
	n.a.	Inadequate Protection Risk	Inadequate Protection Risk	Inadequate Protection Risk

we organized consumer expectations about insurance policy coverage into four categories, each of which raises distinct consumer protection concerns (See Table 1). Ayres and Schwartz (2014) used the concepts of optimism and pessimism in a way that is similar to, but not precisely the same as, the way we use these terms in this article; otherwise, the categories are original to us. Although our approach neatly sorts consumers’ expectations about their insurance coverage into four categories, it is also possible that consumers’ beliefs vary across different settings, such as the type of coverage at issue.

First, consumers’ coverage expectations might be roughly accurate. That is, insured consumers who have not read or understood their policies may have expectations that tend to coincide with the reality of what the policy language covers. We call such individuals “coverage realists.” Second, insured consumers may have no expectations whatsoever regarding whether their insurance covers any particular loss (Thomas, 1998), a group we call “coverage agnostics.” Third, insured consumers may be “coverage pessimists” in that they assume that their policy *will not* cover their losses, *even when the policy terms indicate coverage*. Finally, some insured consumers may assume that their insurance policy *will cover* losses that befall them, *even when the terms of the policy state otherwise*. We label these individuals “coverage optimists.”

The last of these four categories - coverage optimists - presents the most significant potential problems for insurance markets. First there is the possibility of over-priced coverage. That is, a coverage optimist may be willing to pay premiums that reflect their mistaken expectation that the policy will cover a loss it will not. Ayres and Schwartz (2014) have suggested that consumer optimism can lead to overpriced insurance policies, espe-

cially in the absence of market competition. Although competition among insurers would help to offset this risk, this advantage is undermined by consumers who tend not to comparison shop once they initially select coverage, a specific manifestation of the well-known status quo bias (Samuelson & Zeckhauser, 1988). Insurers that can identify these policyholders using either conventional predictive models or more modern tools that rely on big data or artificial intelligence can exploit their coverage optimism by increasing their rates.

Second, and alternatively, if competition forces insurers to price their policies at roughly marginal cost, coverage optimists might actually *not* be paying for coverage that they *believe* they have. Then coverage optimism can cause consumers to believe (from their *ex-ante* perspective although not from the consumer’s *ex post* perspective nor from the insurer’s perspective) that insurance policies are underpriced as they think their policy covers more than it does. Underpriced coverage, in this narrow and specific sense, can be a cause for concern, because it can worsen a particular type of moral hazard (Baker, 1996).

Consider a homeowner who lives on a coastline and believes their homeowners policy covers certain catastrophic weather-related damage to their home when it does not. Some of these consumers may be more likely to build or purchase homes in this area than they would have been had they (i) not had insurance or (ii) been forced to purchase insurance that was priced to cover the risk. Thus, as in this example, coverage optimism can drive a wedge between the actual cost and perceived cost of insurance, thereby incentivizing socially wasteful construction in high-risk areas or similar forms of moral hazard (Ben-Shahar & Logue, 2016).

Yet a third potential problem with coverage optimism is that it can create perverse incentives for insurers to either limit the coverage they provide or fail to expand that coverage to reflect new risks. Even in relatively

² A moral hazard occurs when there is an incentive for someone to change their behavior depending on whether or not they are insured.

non-competitive insurance markets, insurers generally have good incentives to design policies to provide the types of coverage for which consumers would be willing to pay. By contrast, when consumers are coverage optimists, insurers are unlikely to suffer commensurate market penalties if they choose to hollow out their coverage or not to adapt that coverage to reflect new risks (Schwarcz, 2012). So long as consumers remain coverage optimists despite these changes (or failure to adapt), insurers can save money on claims payments without suffering decreased demand for their coverage. Even more perniciously, insurers in competitive markets composed of coverage optimistic consumers can be compelled by market forces to hollow out or fail to adapt coverage; failure to do so if their competitors are adopting this strategy can result in losing customers to those competitors who offer better prices.

The fourth, and perhaps most serious, concern with coverage optimism is that it can cause individuals to suffer life-changing financial disasters that they might have avoided either by changing their behavior (say, not building their homes so close to the coast) or by purchasing a separate insurance policy that in fact covered the loss. A coverage optimist who believes their existing insurance policy covers a particular catastrophic loss when in fact it does not has no incentive to shop for or pay the additional premium to purchase a separate policy that would in fact cover that loss (Schwarcz, 2014). Then, if a catastrophic loss happens, the individual could lose the entire value of the equity in their home, along with all of their personal possessions. In other words, coverage optimism can lead not only to a misallocation of resources (houses being built where they should not be) but also to substantial financial disasters.

At least some of the four potential costs of coverage optimism - (i) over-pricing, (ii) moral hazard, (iii) restrictive policy terms, and (iv) inadequate risk protection - can also exist when consumer understanding of insurance policy terms is inaccurate in other ways. For instance, coverage agnosticism can almost certainly cause the latter two consumer protection harms. When consumers simply do not have concrete expectations about the coverage they purchase, insurers will be able to profit in the short term by unreasonably restricting or failing to adapt their specific terms of coverage. Moreover, although coverage agnostic individuals have few specific expectations regarding their coverage, they might still be willing to pay

for additional coverage were they to become aware of its costs and benefits (Thomas, 1998).

Like coverage agnosticism, coverage pessimism can also plausibly result in excessively restrictive policy terms and inadequate risk protection. When consumers believe that insurers will not pay for coverage that is explicitly provided for in their policies, they are unlikely to respond to market innovations, such as policies with expanded coverage. This, in turn, creates strong incentives for insurers to hollow out their coverage, which can then compel other insurers to follow suit. The prospect of inadequate risk protection for coverage pessimistic consumers is even more straightforward: if consumers do not expect insurers to pay for the coverage that their policies provide, then they will have little reason to pay for all of the coverage that they would want if they had more confidence in their insurers. Further, because coverage pessimism can persist at the claims stage, it can result in a consumer deciding not to file a claim when the loss in question would in fact be covered (Sommers, 2021). This possibility can exacerbate other insurance market problems. For example, if insurers come to expect that their insureds will not file claims for certain types of covered losses (owing to coverage pessimism), there is increased pressure for the coverage price to not fully reflect risk, causing potential moral hazard.

All of these insurance market problems, which can result when consumers do not understand the language in their insurance policies, can be ameliorated if even a small number of market intermediaries do understand that language (Schwartz & Wilde, 1983). For example, an insurance broker who understands a policy's coverage can educate their customers about that coverage. Likewise, they can steer consumers away from insurers who tend to write especially unclear or one-sided policies, which creates a disincentive for insurers to engage in that practice (Schwarcz, 2014). Also, a state insurance regulator who understands a given insurance policy's terms is in a better position to police the terms of that policy's coverage (Schwarcz, 2017).

B. Promoting Meaningful Assent

Although the vast majority of consumers may never read their insurance policies, courts nevertheless regularly enforce unambiguous insurance policy terms. This is be-

cause there is a meaningful sense in which consumers can be said to have assented to those terms (at least the not patently unreasonable or socially objectionable ones) notwithstanding having never read them, so long as they had an opportunity to read those terms. This idea, sometimes understood as the concept of “blanket assent,” plays an important role in the modern justification for enforcing standard form contracts, including insurance contracts (Llewelyn, 1960; Rakoff, 1983). But the blanket assent principle is strongest when the terms of the contract are not only unambiguous but also comprehensible; otherwise, consumers never had a meaningful initial opportunity to read those terms in the first place, meaning that their decision not to do so was, in fact, not a choice at all (Radin, 2012).

C. Promoting Fair Claims Handling

Policyholders can be vulnerable to insurers’ unfair claims-handling practices. By the time the loss has occurred, and the insurer is contractually obligated to pay the claim (assuming it is covered), the policyholder has no other option to cover the loss; once the loss happens, it is uninsurable (American Law Institute, 2019). If the insurer unreasonably delays or denies the claim, the policyholder faces a possible financial catastrophe. This possibility is reduced insofar as the policy terms on which the insurer bases its denial decision are clear and comprehensible (Boardman, 2009; Schwarcz, 2017).

As previously mentioned, even if consumers do not read their policies at the time of purchase, they are much more likely to do so when there is a large loss followed by a claim denial. This is especially true when state law requires the insurer to identify the policy language that formed the basis of the denial decision. The risk of an unreasonable claim denial or delay is reduced when the relevant policy language is clear and comprehensible because of the availability of extra-contractual damages when insurers violate their coverage obligations in bad faith (Schwarcz, 2017). Also, if an insurer were to deny a claim notwithstanding clear and comprehensible policy language requiring coverage, they would risk prompting regulatory scrutiny under the state’s unfair claims handling practices laws (Schwarcz, 2017).

III. Legal and Regulatory Strategies to Promote Consumer Understanding

Given the value of comprehensible insurance policies, it is no surprise that U.S. insurance law and regulation seek to promote this goal, as do laws and regulations in other countries (see, for example, van Boom et al. (2016) for a discussion of European Union rules instructing financial services providers to communicate in a “clear, fair and non-misleading way”). Although the specific approach varies across states, most jurisdictions embrace one or more of at least five distinct tools to promote transparent insurance policies in personal lines markets. Three of these - quantitative readability rules, qualitative readability standards, and mandated disclosures - are implemented via statute and/or regulation. The remaining two - *contra proferentem* and the reasonable expectations doctrine - are legal doctrines that courts implement.

A. Quantitative Readability Rules

Most states in the U.S. require that certain insurance policies meet minimum “readability” standards (Schwarcz, 2014). In the U.S., only Kansas, Mississippi, Utah, and Washington do not have such laws (Blasie, 2022). In many cases, state laws require that personal lines policies - such as homeowners and auto policies - meet specific quantitative thresholds based on readability formulas, such as the Flesch-Kincaid Grade Level formula or the Flesch Reading Ease Test (Blasie, 2022). These tests use objective features of documents, specifically word and sentence length, to estimate the difficulty individuals would have comprehending a written document (Cogan, 2010). The specific scores that insurance policies must meet under these laws vary by state, and sometimes even within states across different types of insurance policies (Blasie, 2022). Compliance with quantitative rules (vs. standards) is relatively easy to assess and enforcement can be achieved through straightforward strategies (Kaplow, 1992), such as insurers’ affirmations to regulators of compliance with applicable requirements.

B. Qualitative Readability Rules

In addition to quantitative readability requirements, many states have laws requiring that personal lines insurance policies meet qualitative readability requirements. Often, these requirements are stated in law and regulation at an extremely high level of generality, requiring, for instance, that insurance policies be written in “plain language” or “plain English” (Blasie, 2022). Sometimes, these broad concepts are explained a bit more fully. A Minnesota law, for instance, requires insurance policies to “use policy and contract forms which are written in simple and commonly used language, which are logically and clearly arranged, which are printed in a legible format, and which are generally understandable” (Readability of Insurance Policies Act, 2022).

Because of the high level of generality of qualitative readability standards (vs. rules), the mechanisms by which they are enforced are crucial in determining their ultimate impact (Kaplow, 1992). In virtually every state, this enforcement occurs principally through the form filing process, under which insurers must file with state insurance departments copies of any new policies or endorsements they wish to offer in the marketplace.³ In many cases, state regulators must approve these policy forms before they can be sold to consumers (“prior approval”), though a non-trivial number of states allow filed policies to be sold if they are not disapproved after a specified period of time (“file and use”). Some states allow insurers to use a policy form if it is filed within a specified period of time thereafter (“use and file”) (Abraham & Schwarcz, 2022; Cope, 2022; Tucker, 2009). Some states explicitly authorize state regulators to disapprove a personal lines insurance policy if it is “misleading,” “ambiguous,” or “confusing” (Cope, 2022; Schwarcz, 2014). And, of course, state regulators generally have the power to disapprove of any form that does not comply with state laws, including laws that require those policies to be written in “plain language.” According to state insurance regulators, these rules ensure “that [insurance consumers’] rights and responsibilities, and those of the insurance company, are clearly stated” (NAIC, 2010).

³ States often have various exemptions from form filing requirements for large commercial risks. Also, in the majority of states, an Interstate Insurance Product Regulatory Commission (n.d.), not the state regulator, approves life, annuity, disability income, and long-term care insurance products.

C. Mandated Disclosures

Many states mandate via statute or regulation that insurers provide consumers with a variety of disclosures at some point during the insurance purchase and renewal process. These disclosures give consumers information about a range of insurer practices, including insurers’ privacy policies (NAIC, 2017) and usage of specific rating and underwriting factors (see, e.g., Disclosure of Credit Reports, 2022; General Rules Governing Insurance, 2011; Private Passenger Automobile Liability Policy; Disclosure; Requirements, 2001). They also commonly alert consumers to the availability of state guarantee funds that protect against insurer insolvency (NAIC, 2018). In most cases, however, these mandated disclosures do not attempt to highlight or summarize particularly important insurance policy terms or conditions (Schwarcz, 2014). Instead, in personal lines auto and homeowners insurance, the policy itself, including the declarations page, is the only information that insurers are typically required to provide to consumers about the scope of their coverage. By contrast, ERISA - a federal law governing employee benefit plans, including plans that deliver insurance benefits - requires plans to provide consumers with a “summary plan description,” which must “be written in a manner calculated to be understood by the average plan participant” and be “sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of their rights and obligations under the plan” (Summary Plan Description, 1974).

To be sure, there are occasional exceptions to these generalizations, where states do indeed mandate disclosures pertaining to the scope of coverage in insurance policies not covered by ERISA or other federal laws. For instance, many states require property insurers to disclose exclusions for flood or earthquake (see California Earthquake Authority, 2018) (earthquake); Flood Insurance Notice, 2007) (mudslide or flood); Notice Regarding Earthquake Exclusion, 2012) (earthquake); Notice Regarding Flood Damage Coverage, 2013 (flood); Required Disclosures for Residential Homeowner Policies, 2013 (flood). The distinguishing features of these exclusions are that consumers can typically purchase supplemental coverage specific to the excluded perils through public insurance programs. A handful of states also require disclosure of other types of specific insurance policy terms in personal lines insurance policies, such as an auto insurance policy’s

coverage of rental vehicles (Personal Automobile Insurance, Rental Vehicle Coverage, 2019). Finally, and most significantly, at least two states - Colorado and New Jersey - require insurers to provide a summary disclosure that offers a simple explanation of the policy's major coverages and exclusions as well as its terms governing cancellation and nonrenewal (Customer Information Brochure for Homeowners Insurance consumers, 2013; Summary Disclosure Forms Required, 2019).

Outside the U.S. the German implementation of the European Union Directive 2002/92/EC to Advise and Disclose requires insurance agents to give consumers “fact sheets” before they apply for coverage. The fact sheets describe the insurance product and its insured and excluded risks, as well as the amount and timing of premium payments and ways to cancel the contract. However, the disclosures appear to have had limited impact on consumer understanding, in part because the information in and the format of the fact sheets are not standardized. The information is often delivered electronically, and the consumer may never see it (Schwarzbach & Weston, 2016).

D. Contra Proferentem

In addition to regulatory and statutory strategies that promote consumer comprehension of insurance policies, several key judicial doctrines of insurance law also are intended in significant part to promote this goal. The most important such doctrine is *contra proferentem*, or the rule that ambiguities in insurance policies are interpreted against the insurer, which Abraham (1996) has been described as the central principle of insurance law. Insurance policy language is ambiguous under this doctrine when it is reasonably susceptible to two or more meanings in the context of a specific coverage dispute (American Law Institute, 2019). The central rationale for this interpretive principle is that it incentivizes insurers to draft unambiguous policy language to avoid unfavorable judicial rulings in coverage disputes (Boardman, 2013). This clarity of policy terms, it is often assumed, can help to promote policyholders' understanding regarding the scope of their coverage (Abraham & Schwarcz, 2022).

E. Reasonable Expectations Doctrine

Another familiar rule of insurance law that is intended in part to promote more comprehensible insurance policies is the reasonable expectations doctrine, which has been the subject of a large and often critical literature (Abraham, 1981). Although few states now endorse a strong version of the doctrine that would allow them to disregard the unambiguous meaning of policy language (American Law Institute, 2019), a non-trivial number of states continue to consider policyholders' reasonable expectations of coverage when interpreting policy language and assessing whether that language is ambiguous. In most cases, this merely amounts to interpreting policy language as an ordinary consumer unschooled in the details of insurance would understand it (*Burton v. Ky. Farm Bureau Mut. Ins. Co.*, 2010). In rare cases, courts go a bit further, insisting that the doctrine allows them to disregard policy language that is “overly technical or contains hidden pitfalls, cannot be understood without employing subtle or legalistic distinctions, is obscured by fine print, or requires strenuous study to comprehend” (*Zacarias v. Allstate Insurance Company*, 2021).

Like the ambiguity rule, a central rationale for the reasonable expectations doctrine is that it can promote comprehensible insurance policy language. It can accomplish this, the thinking goes, by discouraging language that is excessively complex or hyper-technical. Under the more common weaker version of the doctrine, courts would be more likely to deem such language ambiguous, and hence to construe it in favor of coverage. By contrast, under the stronger - though increasingly rare - version of the doctrine, consumers might even be entitled to the coverage they believe they bought, irrespective of whether they read or understand their policy (Schwarcz, 2007).

IV. Existing Evidence Regarding Consumers' Understanding of Their Insurance Coverage

Despite the regulatory and legal importance of consumer understanding of their insurance policies, there is remarkably limited empirical evidence on point. This evidence can be subdivided into two basic categories: (i)

Empirical academic studies related to consumer understanding of insurance coverage and (ii) Industry or regulatory assessments of consumers' understanding of insurance coverage.⁴

A. Empirical Academic Studies Related to Consumer Understanding of Insurance Coverage

Only a handful of academic studies have empirically assessed consumers' understanding of insurance coverage outside the health insurance setting (Kirsch, 2002). The most relevant of these is a study using data from an online survey to evaluate the impact of a Dutch insurance company's changes to the terms of an auto insurance policy. The changes were voluntarily undertaken to improve the policies' readability but not to alter the scope of coverage (van Boom et al., 2016). Participants in the study were first given a basic coverage scenario involving an auto accident. They were then asked to assess their coverage rights based on either the pre-revision or the post-revision policy. In a follow-up study, participants were also given a coverage denial letter.

The survey provided some evidence that the insurer's efforts to craft a more readable policy impacted consumers' capacity to understand their coverage and to pursue payments of contested claims. Survey participants who were provided with the revised and more readable version of the insurer's policy reported they found it easier to understand than did participants who received the original version of the policy. Perhaps more significantly, survey participants given the more readable policy expected a larger claim payment, on average, than did participants who received the less readable policy. Curiously, however, the study found mixed evidence regarding the relationship between policy readability and participants' willingness to contest coverage (as opposed to their expectations of coverage). On one hand, survey participants who saw a claim denial letter were more likely to seek information from their insurer, family, and friends, and to initiate

legal proceedings or formal complaints to the extent that they expected a relatively large portion of their claim to be covered. On the other hand, however, the study found no direct relationship between the readability of the insurance policy that consumers saw and their willingness to challenge the insurers' claim denial (van Boom et al., 2016).

A second much earlier study did not directly examine consumer understanding of policy language but instead evaluated the effectiveness of disclosures. Formisano (1981) concluded that mandated life insurance disclosures cannot fully inform consumers about their coverage at the time of purchase. The study evaluated the NAIC's Model Solicitation Regulation, which required insurers to provide purchasers of life insurance with both a generic life insurance buyer's guide and a policy summary sheet describing key details about the specific policy being purchased. These details included the annual premium, death benefits, and cash value, among others. The study's author conducted interviews with almost 200 life insurance consumers several months after they had purchased coverage. The majority of those interviewed did not recall receiving a buyer's guide, and only about 30% reported that they looked at the buyer's guide during the sales process. A higher percentage - about two-thirds - recalled receiving a policy summary sheet. A significant number were not able to correctly identify basic features of their policies or to answer basic questions about life insurance more generally. Importantly, however, the study did not compare understanding among consumers who received disclosures against those who did not, meaning there are significant limitations in interpreting its results.

A third relevant study also did not directly examine consumer understanding of policy language. Solan et al. (2008) evaluated survey respondents' analysis of two hypothetical insurance loss scenarios, finding that respondents were equally likely to conclude that coverage would be provided in uncovered scenarios as in covered scenarios. The study design asked respondents to determine whether insurance would cover situations described in vignettes implicating a pollution exclusion in a liability insurance policy and an earth movement exclusion in a property insurance policy. In each case, respondents were split into an insurance version (where coverage would be available) and an exclusion version (where coverage would not be available). The study found no significant difference in how respondents assessed

⁴ We used a variety of search tools and queries to identify studies relating to consumer understanding of insurance coverage. In particular, we searched for relevant results using Google, Google Scholar, Westlaw, and Lexis. We also reviewed all of the studies we were able to locate in this fashion to identify the sources they relied upon, as well as any newer studies that we were able to identify.

the likelihood of coverage in the insurance and exclusion versions for both the pollution and earth movement scenarios. Solan et al. also found that respondents significantly overestimated the extent to which their interpretations of the two scenarios would be shared by others. This result, moreover, applied not only to ordinary study participants but also to a group of state and federal judges who took a similar survey.

Importantly, the primary aim of the Solan et al. study was not to measure how well respondents understood policy language. Instead, the researchers sought to assess the extent to which respondents disagreed with one another and overestimated the extent to which their interpretations would be shared by others. As such, one of the two vignettes did not include any actual policy language, while the second included only a single relevant line of policy language. And in both cases, the vignettes provided subjects with simplified explanations of the applicable policy language. A recent study extended Solan et al.'s methodology and reported "considerable unexplained variation" in the respondents' interpretations of policy language (Waldon et al., 2023).

In contrast to the dearth of academic evidence regarding consumer understanding of property/casualty and life insurance products, a significant body of academic research evaluates consumers' understanding of health insurance products (see, for example, Kim et al., 2013 and Loewenstein et al., 2013) and concludes that consumers have a very poor understanding of their health insurance coverage. Much of this research, moreover, evaluates the effectiveness of efforts to improve understanding through mechanisms such as simplifying policy choices or disclosures (Consumers Union, 2012; Day & Nadash, 2012; Kingsdale, 2010). Unfortunately, the unique economic and regulatory features of U. S. health insurance markets make it hard to extrapolate from these studies to other insurance contexts. Health insurance products are more salient for most consumers than other insurance products, are used by consumers much more consistently than other types of insurance products, are governed by a different set of state and federal laws than other insurance products and are either principally sold in the U.S. through state-based insurance exchanges or provided as an employee benefit.

Several academic studies have evaluated the effectiveness of insurance-based disclosures regarding topics other than the scope of coverage provided by a non-health insurance policy. For instance, one study used focus groups

to examine the effectiveness of several mandated insurance disclosures concerning policyholder privacy rights, rights to guarantee fund protection should a life insurer become insolvent, and the risks of replacing existing life insurance or annuity products with substitutes (Cude, 2006). Cude reported that most respondents had trouble understanding the disclosures and did not tend to read them at the time of purchase. Another study evaluated the effect of oral disclosures regarding insurance agents' commissions or the ratio of expected payout to premiums. deMeza et al. (2010) found that these disclosures had virtually no effect on subjects' purchasing decisions in a high-stakes experiment.

Additionally, some empirical research has examined the impact on insurance policies of legal strategies designed to promote insurance policy transparency. For instance, one recent study found that insurers crafted much of the language in modern homeowners insurance policies to clarify policy language that courts had found ambiguous (Schwarcz, 2020). The same study also found that this has, over time, resulted in significantly lengthier and more detailed policy language, a result that may have the perverse effect of impeding consumers' ability to understand the basic elements of coverage. Moreover, there are well-known examples where court determinations that policy language was ambiguous have not induced insurers to redraft policy language (Boardman, 2006; Boardman, 2013; French, 2017).

Outside of the insurance context, numerous studies have investigated how well consumers understand other types of financial contracts, such as mortgages and auto finance agreements. The literature on efforts to improve consumer understanding through disclosures, consumer education, and more readable contracts is also wide ranging (Adler, 2012; Garrison et al., 2012; Lacko & Pappalardo, 2010; McElvaney et al., 2018). Overall assessments of how well such policy interventions can work are, however, mixed. Some notable commentators have persuasively argued that most studies find limited evidence that mandated disclosures significantly improve consumer understanding (Ben-Sharar & Schneider, 2014). Others have reached similar conclusions regarding efforts to promote consumer financial literacy (Willis, 2008). By contrast, some commentators offer a more hopeful evaluation of the evidence, even while recognizing that mandated disclosure and consumer education often fail to achieve their goals. These commentators emphasize that certain types

of smart disclosure strategies that are empirically tested and developed are indeed effective in some settings, even if they rarely, if ever, can fully achieve regulatory goals (Bar-Gill, 2015; Bertrand & Morse, 2011).

B. Industry and Regulatory Studies Related to Consumer Understanding of Insurance Coverage

In addition to academics, other actors, such as insurers, popular media outlets, and state regulators, have conducted a number of studies about insurance policy language. For instance, a recent *Forbes* survey of 2,000 U.S. homeowners found that the majority have basic misconceptions regarding their coverage. In some cases, they were unaware that their insurance covered certain risks (Metz, 2022). More than two-thirds of respondents were unaware that their policy included liability insurance protection if their dog bit someone else or their child kicked a ball through a neighbor's window. In many other cases, though, consumers believed they were covered for risks that homeowners' policies typically exclude. For instance, 40% of respondents wrongly believed that a standard homeowners policy covers earthquake damage and 36% wrongly believed that it covers flood damage. Various similar surveys conducted by regulators and insurance companies have found that sizable percentages of consumers have erroneous general understandings of insurance, not realizing, for instance, that homeowners policies do not generally cover the risk of earthquake and flood (Boardman, 2009).

One industry survey suggests that this persistent consumer confusion about insurance coverage may be linked to the complexity and length of insurance policies. A 2013 survey commissioned by Nationwide Insurance found that about 40% of respondents reported having read their current insurance policy in its entirety in the year prior to the survey, and only about 20% reported that they completely understood the details in the insurance policy they purchased (Nationwide, 2013). Survey respondents were much more likely to describe their policies as "too long," "confusing," "complicated," or "overwhelming" than to describe them as "clear," "simple," or "easy to understand." However, the survey did not ask respondents to examine an insurance policy, either their own or a sample policy.

V. Empirical Research to Assess Consumer Understanding of Insurance Coverage

Empirical tests of the research questions posed in the previous sections could take multiple forms. However, we propose a two-prong approach involving both quantitative and qualitative research using data from consumers who own homeowners insurance policies. The first quantitative stage of this inquiry could consist of a survey of a nationally representative sample. An initial set of survey questions could ask respondents about their homeowners insurance policy - how they bought their current policy (e.g., online, from an agent, from an insurance app, by phone, etc.), the type of homeowners insurance policy (as well as whether they have supplemental policies such as earthquake, flood, and umbrella liability coverage), the sources of information they relied upon when they bought their current policy, their experience with filing claims, and whether they have ever read their current policy and, if so, when and why, and if not, why not.

A survey could then explore how well respondents understand insurance policy language by asking two groups of respondents to assess whether a homeowner's policy would cover losses described in several different vignettes. One group of respondents could be asked to predict the likelihood of coverage in these vignettes without seeing any relevant insurance policy language, while the second set of respondents could be asked to answer the same questions with the aid of the applicable policy language. One key question that could be addressed using this approach would be the extent to which giving survey respondents relevant policy language improves the accuracy of their coverage assessments or their confidence in those assessments. More specific analysis could then be conducted regarding whether changes in respondents' coverage assessments resulting from access to policy language were correlated with their experiences with homeowners insurance; the sophistication of the policy language; whether the respondents are coverage realists, agnostics, pessimists, or optimists; and their demographic characteristics.

Another quantitative approach might assess the impact of disclosures on consumer understanding of their insurance policies. Sunstein (2010) described disclosures as "highlight(ing) the most relevant information in order

to increase the likelihood that people will see it, understand it, and act in accordance with what they have learned.” Online experiments in which consumers are shown policy language with and without disclosures designed to call their attention to the most relevant information could be used to test the disclosures’ effectiveness. The disclosures could be specific; for example, a disclosure could highlight an important exclusion in the policy and be linked to the relevant policy language. Or the disclosures could be summary disclosures, such as the ones required in Colorado and New Jersey (Customer Information Brochure for Homeowners Insurance Consumers, 2013; Summary Disclosure Forms Required, 2019). In either case, the disclosure would be tested with consumers before being used in the research to ensure that the format and content are designed to maximize consumer understanding.

A second, qualitative stage of the research could usefully supplement the quantitative data by generating more textured information about how consumers respond to and attempt to digest insurance policies. During this second stage, researchers could conduct cognitive interviews in which interviewees are asked to review a sample homeowners insurance policy and “think out loud” as they read and attempt to understand the policy. Initial interview questions could ask the interviewees to provide generalized reactions to the policy, and to note what portions of the policy seem particularly notable or important. Interviewees could then be asked to consider whether the policy would cover a series of specific losses, including some of the scenarios used in the survey research, and to explain their reasoning. For each coverage scenario, interviewees could first be asked to locate the relevant language within the policy. To the extent that interviewees have difficulties with this task, they could then be directed to the relevant language by the interviewer.

While the above proposals are focused on evaluating consumer understanding of insurance policy language in general, researchers could also attempt to assess the impact of different versions of policy language by integrating variations into either the qualitative or the quantitative stages of the study, or both. For example, respondents could be shown policy language that experts consider more or less readable, as in van Boom et al.’s (2016) study. It would be less important, in our view, to assess how variations across different regulatory settings or jurisdictions might impact consumers’ understanding of policy language. Although regulatory rules and enforcement do

indeed vary across states (as described above), there is limited evidence that these variations produce meaningful differences with respect to the comprehensibility of policy language. In fact, virtually all insurers adjust to state-specific regulatory requirements governing their policies not by altering the language in their base policy, but instead by adding state-specific endorsements to these policies. Consumers face significant challenges deciphering the impact of these amendatory endorsements because they typically amend various specific provisions within the base policy (Schwarcz, 2012).

VI. Conclusions

For individuals who suffer a sudden catastrophic loss, the most important contract in their lives may be an insurance policy. Because courts in the vast majority of cases enforce the language of policies as written, the precise meaning of policy terms can be critical. Focusing on the example of personal lines insurance in the U.S., this article explains why it is critical that the language in insurance policies be comprehensible (not only to consumers but, perhaps more important, to various intermediaries), identifies the regulatory tools that are or can be used to ensure such comprehensibility, reviews the existing literature about how well consumers comprehend their insurance policies, and proposes a new strategy to study consumers’ understanding of the terms of homeowners insurance policies and, even when they have not read their policies, their expectations about coverage. In subsequent work, we will attempt to carry out this research strategy.

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