

Who are you insuring anyway?

by

Joshua Gans
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It has become very common practice in many tenders and supply agreements for the customer to require that all bidders have adequate insurance. This is usually in excess of a million dollars in professional indemnity or related coverage.

The simple story behind this is that customers are insisting upon it because it protects them against the negligence or other problems that might be caused by a supplier. This is especially the case if the supplier was small and could not afford to pay for large damage should it arise.

However, the requirement is hardly a free lunch. With ever increasing premiums, potential suppliers will need to recover these costs in the bid prices. Competition won't eliminate a real cost like this and so it is really the customer who ends up paying.

If this is the case, is it worth it? After all, the customer may already have their own insurance to cover such eventualities or if they are large – like a government – could afford to self-insure. Thus, there is a sense that you are not getting anything extra from insisting a supplier has coverage.

One benefit may come from the fact that not everyone can get insurance. Past poor performance or a lack of professional standards may cause a supplier to be denied coverage. In this case, insisting upon coverage is just another way of screening potential suppliers for quality. But again, one has to ask if that is worth the costs?

Those costs can be considerable. For one, there is the effect on competition itself. Not only are premiums built into bids, in some cases, those premiums may make entry prohibitive. Smaller suppliers may not independently operate and those who do have coverage will have some market power. So the tender price may well be higher than the premium costs themselves.

In addition, a supplier with insurance is a supplier protected, in part, from the consequences of their own actions. This gives rise to a situation the economists' term *moral hazard* whereby the insured take less care to avoid problems. It applies to those with health insurance who consume fatty foods or those with home insurance not locking their doors properly. For suppliers, a lack of care can be more serious.

The upshot of this is: a customer has insisted upon insurance to protect themselves against the consequences of a lack of care, in the end, may be encouraging precisely that. This is something they will have to pay for. The supplier is insured but are you?

The alternative is not putting in an insurance requirement. A supplier willing and able to bear the risk of a lack of care is one who is more likely to take care. Moreover, you can insure yourselves against their negligence directly. If your own insurers and lawyers would let you, this might be worth considering.

If you are a large buyer, like the government, you might even want to insist that no supplier has insurance! Save the premium and bear the risk yourself. This is, at least, a reason to revisit this so-called innocuous clause.

Joshua Gans is Professor of Management (Information Economics) at Melbourne Business School, University of Melbourne, and an active researcher on competition and outsourcing issues using the tools of game theory. Details of his work are available at www.economics.com.au.