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Book Review

Risky Business: Insurance Markets and Regulation

Lawrence S. Powell, Ed.
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In *Risky Business*, editor Lawrence S. Powell has, in addition to his introduction, assembled nine chapters on the topic of insurance markets that run the gamut from a general history of insurance to using panel regressions to estimate the added cost to consumers of multiple regulatory jurisdictions.

Arnold Kling begins with a primer on insurance. He makes the great point that there are a number of institutions that offer or serve the purposes of insurance without being considered insurers or insurance: Fannie Mae, Freddie Mac, manufacturer and extended warranties, and derivatives such as options and futures contracts.

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In contrast is comprehensive health insurance, which rarely fits the form of true insurance: it pays for routine services which actually makes it prepaid consumption.

Federal deposit insurance was created to address the problem of bank runs. However, it entails moral hazard. Kling reveals that before the Great Depression, banks formed risk pools to address the problem of moral hazard. To Kling, the problem with such private insurance is that an adverse event can occur in which losses are so large that private insurance is inadequate to indemnify all losses. The public, anticipating such a real or imagined event, can start a bank run (pp. 21–22). Sure, but Kling leaves the reader hanging: what happened to these private deposit insurance pools? Certainly they were drained, but why ignore the government causes of the crisis that led to the alleged market failure of private deposit insurance?

Kling believes that natural economies of scope and scale lead insurance inherently towards oligopoly.

> This natural industry structure invites regulation. It raises concerns about the ability of the market to be self-regulating through competition.... Regulation of insurance company soundness has economic justification, in that it can help prevent consumers from being effectively defrauded by companies writing insurance contracts that they lack the capacity to fulfil. (p. 24)

How anyone who has had to file even a small number of insurance claims could assert this is a mystery. It is becoming exceptional to encounter family members, friends, or co-workers who have not been stiffed or stonewalled by an insurance company on a legitimate claim. In case after case, the only help have been private attorneys, with Kling's heroic state regulators nowhere in the picture to supposedly help the average consumer.

Kling's contribution stands in stark contrast to Martin Grace's succeeding chapter, which is composed of five case studies of regulatory failure. From the Florida homeowners' insurance market to the New Jersey, Massachusetts, and South Carolina auto insurance markets, to the workers' compensation insurance markets in Maine, Grace demonstrates again and again the unanticipated effects of regulation and the harm it inflicts on consumers and taxpayers.

Grace cites Harrington's studies showing that over the long run, there is no statistical difference in prices between states in which they are regulated and those in which they are not. So why on earth would any particular state consume the large amount of resources that price regulation demands? Grace also cites Bukame and Ruser, who found that removing price regulation from workers' compensation insurance markets not only reduced premiums but also injuries.

Here is the usual vicious cycle: an adverse event occurs where losses are greater than anticipated. Insurers attempt to re-price their policies to compensate for the unanticipated losses and increased risk. The state rejects these premium increases and thus insurers have to abandon the market. The state becomes both a primary insurer and reinsurer, as artificially low premiums prevent private competition. This significantly increases the risks being taken on by the state, since it has cut itself off from a nationwide or even global insurance pool.

Florida's troubles began when insurers tried to re-price polices in the wake of the costly losses of Hurricane Andrew in 1992. The state stepped in to regulate prices and placed a limit on policy cancellations. High-risk areas were undercharged on their premiums while low-risk areas were overcharged. As insurers began fleeing the state, Florida had to form its own risk pools. It created Citizens Property Insurance Corporation (CPIC), the largest company in the state underwriting homeowners' policies. After State Farm quit writing homeowners' policies in Florida, the state legislature passed a bill reversing some of the earlier price restrictions, but the bill was vetoed by the governor (pp. 36–43).

The auto insurance markets in New Jersey, Massachusetts, and South Carolina displayed the same pattern. New Jersey's high-risk pool of bad drivers exploded in cost because the bad drivers had no incentive to change their behavior. Rate caps and an "excess profits" law were put into place. By 2003, with twenty-five insurers having withdrawn from New Jersey's market, insurance reform brought less stringent rate controls and a repeal of mandatory universal issuance. Companies gradually returned to the state and rates fell (pp. 44–45).

Editor Lawrence Powell contributes a chapter on the use of scoring in insurance markets. An insurance score is a computation

using information from an applicant's credit history to predict the applicant's potential for loss (p. 68). Powell is very much in favor of insurance scoring, and thus his chapter is one long argument in favor of it. It is inexpensive, accurate, and its opponents seem to be mostly driven by misunderstandings about its use. Scoring involves credit variables such as the types of credit used, the length of use, and account status. Race and income are not legal to use as variables (p. 68).

While Powell cites studies that suggest that scoring keeps premiums low among a large number of policyholders and obviates bad risks being subsidized by good ones, some issues remain. First is the issue of privacy. Are all applicants fully aware when they perfunctorily sign on the dotted line that their credit information will be factored into their rate quote? Second, Powell does not explain in detail the theoretical basis for a supposed correlation between credit scores and predicted losses. Intuitively, one can see how a relationship would exist, but not in every case. If Jane Doe loses her job, makes two or three late payments on her credit cards, and then finds work again, why is she now a more careless driver?

Patricia Born and Barbara Klimaszewski-Blettner (hereafter B&KB) perform some interesting if not decisive work in comparing the performance of the highly regulated homeowners'-insurance market versus the performance of the much less regulated commercial-insurance market. The authors regress the three dependent variables of the natural logarithm of loss ratios, losses incurred, and premiums earned on explanatory variables including catastrophic events, the types of insurance lines a carrier writes, the strategy of state regulation, and the firm's total premiums in the U.S. market. They test three hypotheses for each of the three regressions. The authors have much faith in econometric methods, despite the fact that their first regression estimate has a rather unimpressive adjusted R-squared of 0.021.

B&KB feel that their econometric regressions bolster their conclusions that unanticipated disasters increase losses more so among homeowners' insurers than commercial insurers because the latter face much less stringent regulation. Controls on rates significantly inhibit profitability after unanticipated disasters and raise loss ratios.

Regressions notwithstanding, B&KB's economic reasoning is sound. Like Kling, however, they have their unfortunate statist predilections. While they would not extend subsidies to new buildings in high-risk areas, they feel that it would be unfair to force low-income households to move away from coastal areas because they could not afford wind insurance. While they might be correct that "flood stamps" would be more efficient than cross subsidies, a "flood-stamp" program, besides inviting new unintended consequences, would also rightfully elicit questions about fairness *versus* unfairness, namely, why should low-risk inland taxpayers now pay the bill for high-risk low-income coastal households? A strong case could be made that both policies seem unfair.

Eli Lehrer's "'Watery Marauders:' How the Federal Government Retarded the Development of Private Flood Insurance" is probably the most insightful chapter in the book. In 1927 a very damaging flood occurred at the confluence of the Mississippi and Missouri rivers near St. Louis, Missouri. Herbert Hoover's large relief campaign greatly increased the power of the Army Corps of Engineers under the pretense of flood protection (pp. 120–121). An extensive flood in New England helped drive the passage of the National Flood Control Act of 1936. After the 1936 law was passed, the size of the flood control program doubled (p. 121). Throughout the 1930s and 1940s, private insurance was severely under-developed because the Army Corps of Engineers built hundred-year flood walls which reduced risk enough for homeowners (but not enough for insurers) to render private flood insurance too costly.

In 1953, the Tennessee Valley Authority (TVA) began tracking flood-prone areas in and around one hundred and fifty towns and cities in its jurisdiction. At first it used a worst-case standard it borrowed from the Army Corps of Engineers, regardless of whether a flood of such magnitude had actually occurred. This prudential standard fell quickly by the wayside when it was realized that it would eliminate huge areas of development that not only local private and public planners wanted, but TVA as well since part of its mission was spurring development. TVA thus switched to a standard skewed in favor of development that was based on past floods that occurred inside of 60 or 100 miles from proposed development. Outside TVA's jurisdiction, the U.S. Geological

Survey and Army Corps mapped flood plains with roughly the same backward-looking standard (pp. 129–130). By the end of the 1960s, all three aforementioned agencies had laid the groundwork for a national map of floodplains. A very bad die had been cast.

The next milestone was the Southeast Hurricane Disaster Relief Act of 1965, signed by President Lyndon B. Johnson, authorizing the spending of $500 million to assist in repairing damage left by Hurricane Betsy. The National Flood Insurance Act of 1968 covered up to $250,000 in damage to single-family houses and buildings divided into no more than four apartments per building in cities and towns meeting the severely flawed federal flood-plain criteria. The absolute death knell for any semblance of economic and actuarial soundness in the National Flood Insurance Program (NFIP) came in 1973, when Congress authorized coverage to eligible property owners who did not even enroll in the program.

In chapter seven, Martin Grace returns with Robert W. Klein to discuss regulatory regime options for the insurance industry in the U.S. The states have regulated the insurance industry since the early nineteenth century, and the industry overwhelmingly favored this arrangement until about the 1990s, when it increasingly began supporting an optional federal charter (OFC). An OFC would place insurance firms and their agents only under federal regulators by choice.

State-level responsibility for insurance regulation had been bolstered by the courts until *U.S. v. South-Eastern Underwriters* in 1944 (pp. 148–151) when the U.S. Supreme Court's majority had decided that the Constitution's commerce clause applied to insurance and that federal antitrust law could be applied to the industry. The response by the industry and states was the passage of the McCarron-Ferguson Act of 1945 which explicitly recognized state authority to regulate insurance and exempted the industry from antitrust laws to a certain extent (p. 151).

The state-based system is now seen as costly and tedious by the industry. Most industry executives now prefer a single federal OFC-like regulator rather than 56 separate regulators nationwide (p. 151). While the OFC proposal is the most widely supported, another idea is to create a federal framework for state regulators to impose greater uniformity in regulation across states. This would

simulate the effect of an OFC without creating one (p. 165). Known as SMART (State Modernization and Regulatory Transparency), this is the current regulatory environment for Medigap insurance (p. 169). Unlike OFC, SMART would not involve the establishment of a federal bureaucracy. It could also avoid the constant pendulum swing of policy from one regime to another, creating constant turmoil as rules constantly change. Unfortunately, it could also create rigidities that prevent states from best meeting circumstances unique to them (p. 170).

The third major alternative is single-state regulator (SSR), where insurance firms choose one state as their regulatory home. Like OFC, this would provide one body of rules but like SMART it would avoid the establishment of a federal bureaucracy. Further, states would be forced to compete with each other in terms of simplifying their regulations (p. 175).

Chapter eight, by Martin Eling, Robert W. Klein, and Joan T. Schmit, compares U.S. regulation to Europe's. In 1994 the EU implemented insurance regulation of premiums and policies. Solvency I in 2004 established capital requirements. Solvency II for 2012 set principles- and risk-based rules for capital (p. 183). Within the past two decades fixed capital (FC) standards have been replaced by risk-based capital (RBC) standards for solvency regulation around the world (p. 184). The U.S. embraced RBC in 1994. There have been three recent trends in regulation of solvency: recognition of the relationship between assets and liabilities, an emphasis on general principles rather than one-size-fits-all rules, and fundamental analysis that takes into account managerial decisions and other qualitative considerations.

U.S. regulation of insurance is on the state level, where a rules-based, accounting regulatory method is followed. Balance-sheet risk and assessments of management quality are ignored. Financial statement data are examined to determine the extent to which solvency regulations are being followed. This is considered obsolete and now behind the EU and rest of the world. It is also considered by the authors to be a hindrance to U.S. global competitiveness (pp. 185–187). The RBC standard has been lax to prevent regulators from taking actions that would be found unjustified by a closer analysis of a firm's balance sheet. In addition, the data in the RBC formula are static and vulnerable to manipulation (p. 190). Better

would be dynamic analysis customized for the particular firm being analyzed in combination with fundamental analysis of managerial competence, among other qualitative aspects of the firm.

The authors make the case for regulation in arguing that shareholders of insurance firms steer the firm toward risky projects at the expense of policyholders. While maintenance of the firm's name and prestige can serve as a countervailing market force, there is an asymmetry between short-term profit objectives and insurance policy liabilities which extend over the long term. The purpose of the regulator, in theory, is to balance this conflict in favor of solvency. In practice this has hardly worked as the S&L debacle of the 1980s and the banking and insurance debacle of 2008 both demonstrated. Regulators can be captured by the industry to keep insolvent institutions open.

In chapter nine, David Eckles and Lawrence Powell repeat the complaint about insurance being state regulated. They note that some companies are subject to as many as 55 different regulators. (There is a real problem of redundancy in the book when it is read as a whole.) This chapter attempts to measure the costs of many different regulators by examining the relationship between the number of regulators per insurer and two measures of cost (pp. 227–228). The cost proxy dependent variables are expense ratio (total expenses divided by premiums) and inefficiency score (difference in inputs for a level of output). The number of regulators per insurer is the independent variable (p. 230). Two panel regressions are estimated that each include a vector of control variables reflecting geography, lines of business, risk of disaster, firm size, and organizational form. Two fixed-effects variables measuring the impact of the firm and the year are included as well.

After the econometric smoke clears, the authors find a statistically significant relationship between the number of regulators and cost. They find that 2009 data predict roughly a $3 to $5 billion cost savings per year by the adoption of a single regulator compared to 55 different regulators (p. 237). They conclude that a single federal regulator or much more uniform regulation across different states would result in much greater efficiency and thus lower premiums for policyholders. The authors think that states should heed this warning or see their power diminished by a federal OFC.

The final chapter is J. Tyler Leverty's study examining the differences in the effects between single and multiple regulators in the current industry environment. This is done through a comparison between standard firms and risk-retention groups (RRGs), which are the insurance industry's analogue to credit unions in banking (p. 245). The Federal Liability Risk Retention Act of 1986 required RRGs to choose a single home state in which to be regulated and from which it to sell products (pp. 245–246).

Despite the average standard firm issuing policies in 4.8 states while the average RRG issues polices in 8.5 states, Leverty found that RRGs had much lower costs of regulatory compliance. He also found that multiple regulators discouraged firm expansion and played a crucial role in a firm's decision to choose the RRG form over that of the standard firm (p. 246). Costs from multiple regulators were estimated to be about 24 percent over a single regulator (pp. 246–247).

What is so refreshing about Leverty is his concession that his study leaves some important questions unanswered. The superior performance of cooperative RRGs might not be attributable just to the fact that they are regulated in a single state but perhaps because of better management from well-informed owners in the same line of business. Leverty's study also ignores the fact that a decentralized regulatory system, while more costly, could address unique local problems more quickly and efficiently when they arise (p. 262).

Risky Business covers a wide range of topics in insurance that graduate doctoral students in economics or finance could be expected to navigate with little difficulty. Unfortunately, that is not the audience this volume is aimed at. Editor Powell informs the reader in the introduction that "the primary purpose of this publication is to provide clear information and supporting evidence about choices in insurance regulation in a format that is accessible and meaningful to policymakers and consumers." (p. 1)

This is a laudable objective. There is much that consumers and legislators could learn about how insurance first developed in general, in the U.S., and how and when it turned into today's cozy corporatist edifice supported by political revolving doors, lobbyists, and captive demand *via* state mandates.

Unfortunately there is not a lot in this volume that is helpful in that regard. Just about all consumers and most legislators, judges, and state executives (usually formally educated as attorneys) will be lost in the economic jargon and advanced econometrics. However, most egregious in this age of the unraveling Obamacare debacle is the omission of a detailed discussion of health insurance. In two hundred and sixty-five pages, excluding end notes and the book's index, the topic is briefly mentioned only a few times. Some of the studies in this collection are already a bit dated. Editor Powell places them into the dichotomy of 1) making an argument for deregulation (chapters 1–6) and 2) options into which that deregulation could instantiate (chapters 7–10). As this review has attempted to demonstrate, the arguments for deregulation by the contributors are neither consistent nor strong.

Given all the aforementioned concerns, it is hard to conceptualize the optimal market for this book. As the basis for an undergraduate course, it would certainly not be appropriate as a principles-level main required volume. It could play a supplementary role in a principles- or intermediate-level class, but with such limited and selective use as to surely not be worth the cost. Post-graduate or post-doctoral economics or finance scholars who are new to the field of insurance and who desire a volume that will quickly get them up to speed are probably the best target market. Unfortunately it is mostly far above the level of understanding of the part of its intended audience comprised of consumers and voters.