The Journal of Risk and Insurance

DOI: 10.1111/jori.12109

Book Review

Risky Business: Insurance Markets and Regulation, edited by Lawrence S. Powell, 2013, Oakland, CA: The Independent Institute, 311 pp. ISBN: 978-1-59813-116-1.

Reviewer: William L. Ferguson, The University of Louisiana at Lafayette; ferguson@louisiana.edu

Risky Business: Insurance Markets and Regulation is a collection of nine academic essays that explore aspects of the current state-based system of insurance regulation intended for use by both policymakers and consumers. The first essay, by Arnold Kling, provides a broad discussion of the basic economics and politics inherent to the insurance mechanism, helping to establish its role and fundamental importance to modern society regarding the transfer, pooling, and subdivision of losses under conditions of risk aversion and moral hazard. Using actual and hypothetical examples from different lines of business, Kling also discusses the need for regulation of the insurance mechanism, as well as several anomalies that stem from various behavioral and socioeconomic factors, including governmental provision of insurance.

The second essay, by Martin Grace, provides a collection of cautionary case studies examining various causes and effects of recent insurance regulatory failures in several different states and different lines of business. Grace provides a detailed discussion, with timelines, for each failure: in the homeowners insurance market in Florida, the workers compensation market in Maine, and the auto insurance markets in Massachusetts, New Jersey, and South Carolina. All follow a common thread/pattern: some initial price shock or other insurance market disruption that makes that issue politically salient, the rapid development of consumer (voter) and/or other political coalitions intent on combating the issue, hyper-politicization of the issue allowing legislators/regulators/politicians to self-insert themselves into the debate, typically followed by an inappropriate short-run fix (e.g., increased price regulation), with inevitable long-run unintended consequences (e.g., the free market responds through reduction of supply or availability that further exacerbate the original issue).

The third essay, by Powell himself, investigates the effects of credit-based insurance scoring on insurance markets. Powell provides a review of the predictive accuracy of insurance scores since first appearing in the academic literature in 1949, including an examination of the methods and results of several major investigations since (e.g., by the Texas Department of Insurance, EPIC Actuaries, and the Federal Trade

Commission), and also presents abbreviated results from his own empirical investigation. Powell convincingly argues that any deviation from using the most accurate, cost-effective predictor(s) results in unfair outcomes and distortion of the insurance mechanism to the detriment of consumers and society.

The fourth essay, by Patricia Born and Barbara Klimaszewski-Blettner, examines the impact of catastrophes and their differential impact on personal and commercial property insurance market performance. Born and Klimaszewski-Blettner provide solid empirical evidence that rate-filing restrictions constrain the ability of insurers to maintain postcatastrophe underwriting profitability, aggravating risk adequacy, particularly with respect to the more highly regulated personal lines. They argue that deregulation (e.g., allowing greater freedom in underwriting, imposing fewer exit restrictions, and/or postcatastrophe tying obligations), reform of residual market solutions, and reduction of incentive-incompatible premium subsidization situations (e.g., restricting new construction in high-risk areas to reduce externalization of the risk) each would contribute to improved overall insurance market efficiency and competition while enhancing consumer protections. Consumers and taxpayers alike thus would face lower risks and postloss assessments, whereas insurers would be better prepared to deal with mega-catastrophes in the long run.

In the fifth essay, Eli Lehrer provides a detailed history of the evolution and problems plaguing the National Flood Insurance Program (NFIP) since initial adoption of the National Flood Control Act of 1936, as well as the various concurrent disincentives for personal responsibility and against the development of private insurance initiatives. Lehrer asserts the interaction of four major factors led to the current crisis in the NFIP: (1) the massive levee-building program of the Army Corps of Engineers since the deadly 1927 Mississippi–Missouri flooding, creating a false sense of freedom from flooding that encourages otherwise impractical development; (2) inappropriate zoning ordinances promulgated across the country, spawned by distorted flood plain mapping based on the (flawed) Tennessee Valley Authority (TVA) approach of mapping known/historic flood boundaries instead of actual potential floods (i.e., the TVA approach essentially focuses on "moving water rather than risk," thereby exacerbating development in flood-prone areas by not really solving the issues pertaining to flooding, but instead pushing the problem to other areas within the system); (3) private market disincentives/market suppression due to congressionally enacted but unfunded flood insurance statutes in 1956; and (4) congressional gutting and ultimate removal of risk-based pricing from the flood program in 1973 in order to encourage participation.

The remainder of the book considers potential changes to the current system of state-based insurance regulation in the United States. The sixth essay, by Martin Grace and Robert Klein, provides a brief history of U.S. insurance regulation, an outline of its current structure and regulatory functions, and a review of the state versus federal debate. The pros and cons of various alternative frameworks also are presented, from maintaining the *status quo* and/or imposing federal standards (e.g., via the State Modernization and Regulatory Transparency Act), to Optional Federal Charter or even mandatory federal chartering, to single-state regulation (e.g., allowing an insurer to choose which state would be its regulator), to split regulation (e.g., solvency by federal government, market regulation/conduct by states).

The seventh essay, by Martin Eling, Robert Klein, and Joan Schmidt, contrasts insurance regulation in the United States with that of the European Union. Similarities and differences among each framework are presented, with a general focus on solvency and various consumer protections. A nonmathematical discussion of the quantitative development and application of Risk-Based Capital (RBC) standards and the three pillars of Solvency II is presented that should easily be understood by non-academics. Qualitative issues also are addressed, or at least touched upon, including: reporting requirements, reinsurance accounting, early warning/financial monitoring, intervention against troubled insurers, receiverships, guaranty associations, transparency and market regulation of forms, products and rate regulation, among others. A brief literature review of a number of empirical studies providing evidence on the effectiveness of regulation and market discipline also is provided, as are policy implications and areas for future research.

The eighth essay, by David Eckles and Powell, attempts to provide an empirical estimate of the efficiency of uniform property–casualty insurance regulation. Employing data envelopment analysis (DEA) and an unbalanced fixed effects panel data model, Eckles and Powell assert insurance consumers might enjoy pass-through cost savings between $3.2 and $5.3 billion annually under a single (federal) regulatory model, but provide no estimate of the concomitant cost trade-off from decreased state control and/or protections and the associated reduction in premium tax revenue to the states. Further, they offer no direct macro insight or opinion as to whether such savings could or would adequately offset any net cost or increase in risk associated with single regulatory oversight (e.g., avoiding or reducing risk/potential losses akin to the savings & loan industry collapse of the 1980s, or the 2008 banking/mortgage crisis), as well as any potential impact on local policyholder/taxpayers should already fiscally strapped states move to offset lost premium tax revenue with new or other taxes and/or fees, and/or deepen budget cuts to valued local services.

The final essay, by Tyler Leverty, attempts to model the efficiency effects of duplicative state regulation versus competitive federalism over the period 1990–2006 by examining the performance of a unique group of insurers currently primarily regulated under single (federal) authority: risk retention groups (RRGs), which are by statute owner-controlled firms of members engaged in similar or related business activities (e.g., doctors) that insure only their own members' third-party liability exposures (e.g., malpractice). Thus, RRGs essentially are monoline firms with no first-party operations (e.g., no property or workers' comp). Leverty also employs DEA to estimate relative efficiency of firms to "best practice" frontiers across five separate proxy output measures using panel data techniques. Not surprisingly, he finds regulatory compliance costs generally do not increase significantly as the number of jurisdictions an RRG operates in increases (as they still report primarily their one line to one, federal, regulator), and that RRGs are more likely to have been formed to operate in more than one jurisdiction versus forming a standard or multiline insurer (both of which, arguably, are *raisons d'etre* for most RRGs). Using his novel approach, Leverty's regulatory efficiency estimate for the property–liability industry as a whole could result in an annual reduction in total expense loads in excess of approximately \$1.2 billion, which in theory should accrue to the benefit of policyholders. However, Leverty does acknowledge his expense-reduction estimate may also stem in part from informational efficiencies inherent to the RRG structure, as his methodology assumes owner-controlled (specialized) RRGs possess no superior knowledge capabilities or information gathering/cost advantage(s) over standard or multiline insurers (which is unlikely). Moreover, his estimate does not incorporate any measure of the social desirability for state-based regulation to more effectively address local needs or preferences

In summary, *Risky Business* is an excellent collection that offers thorough and thoughtful discourse on the current state of evolution in insurance regulation in the United States. Policymakers, consumers, insurance academics, researchers, students, and other interested parties may find this book highly relevant in helping to understand our regulatory history and the status quo, as well as the debate over alternative strategies for reform. The various essays offer a reasonably objective overview of the issues that is fairly clear and understandable for both technical and nontechnical readers.