When insurers go bust: an economic analysis of the role and design of prudential regulation. By Guillaume Plantin and Jean-Charles Rochet, Princeton University Press, 2007

Alfred Marshall observed some time ago that the “business of economics, as of almost every other science, [is] to collect facts, to arrange and interpret them and to draw inferences from them”. When insurers go bust passes this test in connection with prudential supervision of insurance with flying colours.

The authors provide an informative and succinct analysis – the book is only 100 pages long. They combine a robust knowledge of microeconomic analysis of financial institutions – one author has written extensively about prudential supervision of banks – with experience of supervising insurance firms (the other author is an actuary who has worked for the French insurance supervisor).

There are seven substantive chapters in the book (plus an introduction and conclusions). They cover a rather wide background.

Firstly, there are two chapters setting the context. One chapter discusses the evidence of four recent cases of insurance failures – in different lines of business and different countries. The lesson from these case studies is that the issue is how insurers reacted to external shocks diminishing their wealth – rather than the capitalisation per-se. The market failures are associated with corporate governance. This is broadly consistent with the views that supervisors have expressed in the preparatory work for Solvency II – the European Union overhaul of prudential supervision of insurance.

The book also discusses briefly the current arrangements for financial supervision. This includes a very interesting section setting out actuarial ruin theory and its conceptual limits. The authors conclude these chapters with a reminder that the existence of market failures is not a sufficient condition for regulation to be efficient. The latter requires that costs are lower than the benefits.

Another two chapters explore the factors underlying the market failures in corporate governance. Unlike other goods or services, insurance is sold to policyholders before inputs are bought (in more technical terms, the production cycle is inverted). As a result, the effect of an external shock on net wealth, due, for example, to bad luck, may only result in bankruptcy years later. The corporate governance issue is reflected on management ability to defer the resolution of the external shock. This means that, eventually, the firm’s capitalisation is affected. This is where finance
theory comes to the rescue by showing that the capital structure of a firm is a tool to discipline management. The authors explore the virtues of capital requirements using the analogy of deductibles in an insurance contract. In theory, a capital requirement could be imposed by policyholders but their large number and small individual exposures means that they are unable to do so or to monitor the financial position of the firm. The supervisor has therefore a role as representative of the current policyholders.

Policy prescriptions

Finally, the authors outline a number of policy prescriptions over three chapters. They include six recommendations that form a minimum package: simple ratios derived from the insurer’s accounts; “double trigger” for intervention where the second threshold triggers a transfer of shareholders control rights; an independent but accountable prudential authority; granting control rights to the industry via a guarantee fund; a single accounting standard; and limiting the scope of prudential supervision to insurance companies and groups. From the perspective of Solvency II, I found it intriguing that the authors did not come out in favour of market-consistent valuations which are intuitively more likely to address the corporate governance issues identified earlier.

The authors also explore the role of re-insurance and conclude that it fulfils a vital role by acting as informed provider of finance. This leads them to recommend the collection of detailed information on reinsurance contracts. The last chapter includes a section on insurance groups. The authors suggest that diversification should be taken into account, but note that “the opaqueness of conglomerates may also justify the regulator being more conservative and imposing tighter solvency requirements”. This is implicitly assuming that there is limited scope for supervision to change outcomes. The treatment of EU based insurance groups is an important aspect of prudential supervision and I feel that the authors could have devoted more than seven pages to this.

The European Commission published on July 10 its proposals for a Solvency II directive. The 370 pages of the draft directive provide a fair amount of detail even if the directive only provides a high level framework. Some of the authors’ policy recommendations are reflected in the directive. This book will provide a suitable background to understand aspects of Solvency II. All in all, if I had to choose a genre for this book, I would put in the category of Freakonomics for using economic analysis to shed some light on complex issues.

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