BOOK REVIEWS

Insurance and Behavioral Economics: Improving Decisions in the Most Misunderstood Industry, 2013, by Howard C. Kunreuther, Mark V. Pauly, and Stacey McMorrow, New York, NY: Cambridge University Press.

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Judging solely from its title, this book may seem to be another difficult read about insurance. However, it is actually quite the contrary; through simple explanations of insurance principles followed by examples and analogies, Kunreuther, Pauly, and McMorrow make a fairly successful attempt at explaining insurance concepts that are sometimes difficult to grasp. Throughout the book they relate certain types of human behavior uncovered in psychological and other research to "anomalous" behavior in the insurance industry. They begin by investigating the "benchmark models" of supply and demand using classical economics and then delve in to analyze the role of behavioral economics in creating anomalies that diverge from these benchmark models. The book is directed primarily toward an educated audience; however, no prior knowledge of insurance is necessary (though it would be beneficial when reading this book). For the reader with minimal insurance background, some sections may be a little difficult to understand at first and may require a re-read or further explanation.

The book is divided into several parts, each comprising multiple chapters. The first part, "Contrasting Ideal and Real Worlds of Insurance," discusses the purposes of the book, explains how insurance works, and compares anomalous behavior with that of the benchmark models. Chapters 1 and 2 introduce the concepts of classical and behavioral economics. Chapter 2 also provides a brief, but useful introduction to insurance and explains terms such as "premium" or "risk pooling". Classical economics predicts how an idealized consumer or supplier should make choices, whereas behavioral economics takes into account feelings and emotions, biases, and human imperfections. The baseline approach to insurance, or the standard insurance model of what *should* happen, is based on classical economics; it is called the "benchmark model" of insurance and is discussed in detail in Chapter 4. Anomalous behavior in the insurance industry takes into account behavioral economics and is discussed in Chapter 3.

Part II of the book addresses the influences of consumer and insurer behavior on the insurance market and how they can result in deviations from the benchmark model. Chapter 5 provides an overview of several types of behavior (information asymmetry, adverse selection, and moral hazard) that can result in anomalies; these can apply to both the consumer and the insurer. Chapter 6 outlines several causes for why consumers refrain from purchasing insurance when the benchmark model says they should; for example, consumers may choose to remain uninsured instead of spending money on premiums they expect to never benefit from. Chapter 7 discusses anomalies on the demand (consumer) side, including underpurchase, overpurchase, and purchasing the incorrect type or amount of coverage. Various types of supply models and anomalies on the supply (insurer) side are discussed in Chapters 8 and 9. These types of anomalies can include rate increases or refusing to provide coverage following a disaster; catastrophe models can help insurers predict how they will respond in such situations.

The future of the insurance industry is highlighted in Part III. These chapters offer suggestions on how to deal with some of the most common anomalies. They also discuss some of the benefits of multiyear insurance contracts, including lower costs to insurers and greater consumer coverage, with specific emphasis on flood insurance. Chapter 14 concludes this section and the book by highlighting three main points: 1) consumer or insurer behavior may be inconsistent with that of the benchmark models, 2) anomalous behavior may be more prevalent in certain markets than others, and 3) the public sector can play a significant role in improving situations when insurance markets show anomalous behavior.

One of the great strengths of this book lies in its selection of examples and analogies that help the reader understand a certain concept or principle. For example, Chapter 2 begins with several examples of anomalous behavior, primarily due to simple misunderstandings about insurance. The chapter then goes on to address those misunderstandings as part of its explanation of the basic concept of insurance. The "mini" appendices at the end of a few of the chapters are also a unique addition and offer even further explanation and application for the inquisitive reader. For example, the appendix at the end of Chapter 7 (demand anomalies) outlines a method for estimating the average payout of an Aflac group cancer insurance policy; results show that only nineteen percent of the premium goes toward benefits, and thus there would be little reason to purchase this policy.

As far as improvements, perhaps it would make more sense to place the chapter on benchmark models (Chapter 4) before the chapter on anomalies (Chapter 3). Benchmark models are sort of the baseline for the insurance industry, and any anomalies are deviations from that; thus, maybe it would make more sense to set the foundation for the baseline first before starting to discuss anomalies from that baseline. Also, simple figures could be used more frequently throughout the book to illustrate insurance concepts or examples. Some good examples of this are the flow chart and graph found in the catastrophe models subsection (pages 166-167) or the table in Chapter 2 (page 22) that illustrates the concept of risk pooling.

Overall, this book does a good job at clearing up some common misconceptions about insurance, especially on the consumer (demand) side. Its effective use of examples and visuals add to the reader's understanding. Comprehension of some of the principles may be difficult but, for the most part, the authors get their point across. As the title indicates, the book explains why the insurance industry is often misunderstood, and hopefully after reading this book both consumers and insurers alike will be more prepared to make better, more educated decisions when it comes to purchasing and selling insurance.