

CATO INSTITUTE

POLICY FORUM

INSURING AGAINST TERROR:

IS THERE A ROLE FOR GOVERNMENT REINSURANCE?

Monday, September 23, 2002

Moderator:

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Featuring:

Glenn Hubbard, Council of Economic Advisors;

Anne Gron, Northwestern University;

Scott Harrington, University of South Carolina;

and Debra Ballen, American Insurance Association

The Cato Institute

F.A. Hayek Auditorium

Washington, D.C.

P R O C E E D I N G S

MR. VANDOREN: My name is Peter VanDoren, and I'm Editor of Regulation magazine here at the Cato Institute. And I welcome you today to a forum on terrorism insurance and the role of the Federal Government in that market. We have established and commissioned a distinguished panel of academics and industry participants to have a discussion today.

The first speaker is Professor Glenn Hubbard, who is the Chairman of the President's Council of Economic Advisors. He is on leave from a professorship at Columbia Business School. His B.A. is from the University of Central Florida and his Ph.D. is from Harvard.

Second will be Anne Gron, who is Professor of Management and Strategy at the Kellogg School at Northwestern. Her B.A. is from Williams and her Ph.D. is from MIT.

Third will be Debra Ballen. She is Executive Vice President of the American Insurance Association. Her B.A. is from Princeton and her J.D. is from Harvard.

And finally, Scott Harrington is Professor of Finance at the University of South Carolina Business School. His bachelor's is from the University of Illinois and his Ph.D. is also from the University of Illinois, Urbana-Champaign.

With that introduction, first, Glenn Hubbard.

GLENN HUBBARD,
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS

DR. HUBBARD: Thank you. It's very nice to be here.

I guess I won't make any inference from the fact that I'm over here and all the other speakers are over there, but I think this is one of those topics where that happens.

I have a handout that I won't really walk all the way through, but I wanted to give you a sense of the thought process that the President went through in thinking about the administration's proposal for terrorism risk insurance and a little bit about the pressure points that we see, as an administration, in the legislation that sits in the conference. One of the things at CEA that we began working on almost immediately after the terrible events of September 11th was trying to think through the effects of the crisis on financial markets broadly, and the property and casualty insurance market obviously came almost immediately to mind.

There were really two big shocks that hit the industry as a result of September 11th. One that's relatively easy is just a direct capacity shock. The costs of the disaster were very large by P&C disasters. There is a range of estimates out

there -- \$40 billion to \$50 billion was a conventional range. That is very large relative to the reserves of the property and casualty industry. So, point one, it was big shock to the private sector capacity in the industry.

The second is also an information shock. It's fair to say that the industry had not really thought about terrorism risk as a separate line to be priced. It had been something that had been bundled in generally to P&C contracts. Previous disasters that had been very costly had been more related to natural disasters -- Hurricane Andrew comes to mind. And the industry really didn't have easily a distribution of losses from previous terrorist events from which one could actually price terrorism risk.

The second issue -- what were the mechanisms that you could use to actually spread the risks from disasters like 9/11? Obviously the most conventional thing from an economic perspective is the use of the reinsurance market. But here, traditionally at least, there had been a reluctance by major reinsurance players to hold a large percentage of catastrophe risks. And the global reinsurance market, while having quite a large amount of capital, has a small amount relative to the potential size.

Now, from a market-based economic perspective, I don't view that as particularly a deterrent to the development of a

private market. And let me start with an analogy that might seem a little weak, but try to bolster it a little. And that is the analogy to catastrophe risk in natural catastrophes. If you were to think back to 10 or 15 years ago, the notion of drawing broadly on capital markets to securitize catastrophe risk would have been considered a little farfetched.

Now, of course, it is considered much more prominently. However, even though we have had a lot of thought about catastrophe securitization, cat bonds still have relatively modest trading. So, while this is potentially very important even from natural disasters, the notion that this immediately springs forth to deal with the problem of terrorism risk is probably a bit farfetched.

The problems, as we saw it, with immediate inadequate terrorism risk insurance coverage were that there were key groups that were saddled with essentially undiversified risk -- not just local governments, cities and counties, but a whole variety of not-for-profit institutions, universities, museums, and so on. In the private sector, of course, real estate owners bore the brunt of this through capitalization effects. And I will come back to that in a moment.

We saw a reason, from an economic perspective, a macroeconomic perspective, to care. A lot of this had to do with concern over new construction projects that it would be difficult

to get financing for -- high-profile construction projects, absent terrorism risk insurance, either directly or because financial institutions, the lenders, would be unwilling to bear this risk, and would either charge much more for bearing that risk or not make the loans. There are estimates out there from the Mortgage Bankers Association of America and from the Real Estate Roundtable suggesting quite significant effects on the construction margin, on the new construction margin.

The far larger effects that we were worried about had to do with capitalization and the value of real estate portfolios and, ultimately, in the mortgage-backed securities market. All of these led us to believe that there was a quite significant problem in the very short run for terrorism risk insurance. And while we believed the private market has great potential here to develop, in the short term we believed there were real capacity issues.

Now, having said that, let me take a moment to argue why your starting point should always be letting the private market work. And to me, the first and largest point here has to do with risk mitigation. And I don't mean by this that individual companies can control terrorists. I don't think that is what is meant here at all. But the idea is that it may be possible, and indeed is possible, to control the damage that might occur. That is, hardening of a building, security

procedures -- standard moral hazard arguments. It is markets and insurance prices that give the right incentives for this kind of behavior. So, point one, a key role for markets ought to be in getting incentives right to mitigate risks.

Second would be claims adjustment. I'm going to come to in a moment describing a quite elaborate scheme for involving the government here. If there were to be large claims processing, it is important that private insurance companies have their money on the line, so that there is incentive for very careful processing of claims.

We also believe that crowding out effects are very important. In a wide variety of insurance markets, we know that the presence of government insurance can crowd out legitimate private sector insurance.

Having said that, we believe there was rationale for temporary government intervention -- again, inadequate capacity in the short term, the scale of the losses relative to the short-term ability to get capital into the industry, obstacles in the underwriting process because there is a very limited actuarial basis on which to make underwriting judgments. And from an economic perspective, what was most compelling to me is a variant of the classic Samaritan dilemma problem. If we clarify in advance what the government's policy will be, there is less of

a chance of, ex post, of people coming at the mercy of the government for a bailout.

All of those, we believed in the administration, led to an argument for a bridge. That is, how could you set up a plan that would build private sector capacity in the long run but still take into account some of these short-term effects in the economy that I noted a moment ago?

The administration's proposal is in the handout that I gave you. Let me just summarize the high points of what the President had in mind. First, we wanted something that was explicitly temporary. That is, we wanted to, again, put on notice that we are trying to build private sector capacity here. Research, I said we also wanted to give incentives to private firms to be involved in the right way, so that means private firms taking slivers of the losses throughout the distribution.

So, basically, we started out with a proposal that, in the first year, would have the government paying 80 percent of insured losses below \$20 billion and 90 percent above that, up to a cap of \$100 billion. And then, in each of two years afterward, having the private sector take on a greater and greater share. So that, again, incentives are made stronger and the private sector has time, over that three-year period, to build capital in the insurance industry.

We believe this kind of increasing share of risk-bearing was very important to develop private sector incentives. If you simply say, we'll cover you for several years and then, oh, by the way, after that come in, we don't view that as being very credible as a way to increase incentives.

The legislation that the President had been behind, and is behind, gives a sunset. So that, again, it is very clear that the private sector is to play the main role here.

Another important part of what the President proposed -- and for those of you who follow this in the legislative process knows it is quite contentious -- has to do with litigation. When the government is now going to be on the hook, as it were, for quite large potential sums of money, we felt it very important that this be about the issue of addressing damages directly, not about enriching the plaintiffs' bar. And toward that end we had in mind consolidating terrorism-related claims into a single Federal court, which is just a complicated way of trying to reduce the transactions costs that would be involved in litigation and reduce the potential for venue shopping that often occurs in large litigation.

This consolidation, from a victim's perspective, is good because it also speeds the payment of damages to the actually injured parties. We also wanted to eliminate punitive damages except the terrorist himself or herself. So, this

shouldn't be an argument about making third-party victims suddenly liable in an act of litigation.

These two provisions, consolidating the claims and removing punitives damages, we think do a lot to reduce the costs here, which, again, promotes the development of private sector capacity. These principles have been affirmed in bipartisan compromise. At the beginning of this in the Senate, in the legislative process, Senator Sarbanes had agreed, and Senator Dodd. We also have bipartisan support then from Senators Gramm and Enzi, along with the administration.

In June, the President's economic advisors sent a letter to key Senate members affirming that we would urge that the President not accept any legislation that did not contain these tort provisions, simply because we viewed them as so potentially damaging if not enacted.

So, let me give a quick summary then of where I think all this led us. Bottom line, the argument for government here is, one, at the back end; that is, true catastrophic risk. And second, temporarily.

So, we believe that in the short term many parties were inefficiently saddled with undiversified risk. Economic activity was being delayed or cancelled -- construction, capitalization effects -- and individuals and businesses were exposed to a wide variety of tortious litigation claims that could have been very

costly for the economy. So, we think all of those pointed in the direction that the President took for intervention -- limited, short term, and market based.

Thanks.

(Applause.)

MR. VANDOREN: Anne.

ANNE GRON,
NORTHWESTERN UNIVERSITY

DR. GRON: I would like to thank the Cato Institute for inviting me here.

I am going to address my concerns pretty much to the same types of problems as Glenn has. This discussion is based on some research I did with Alan Sykes at the University of Chicago Law School as well as with Andrew Winton at the University of Minnesota.

I would start by saying that when you look at what happened after 9/11, in terms of the terrorism insurance market, you can sort of distinguish two different types of disruptions that are in the market. One type is dealing with the problems of the small- to moderate-level of losses. Those appear to be mostly cyclic kinds of disruptions, things that we have seen before that are short term in nature, as Glenn mentioned, and

very likely to resolve themselves by themselves -- with some problems along the way, as we will discuss.

The second kind are those impacting very high loss limit exposures. And these represent large-scale, catastrophic-type scenarios which would really be of a mega-terrorism kind of event. And the prospects for a market to provide this kind of coverage is really limited, in our experience, based on other types of insurance -- particularly what we have seen after the catastrophe reinsurance crisis.

The first point I would like to make about all of this is a crisis of affordability and availability are not new in insurance. For those of you who follow the insurance markets, these are things that come periodically. Most recently we had the liability insurance crisis of the mid-1980's, and then there was a crisis, called catastrophe reinsurance but it was in catastrophe insurance overall, in the mid- to early 1990's. And they are really part of a larger pattern of insurance profitability, which is important to keep in mind when you're asking how you want to intervene, how these markets actually work.

The typical pattern is that there is this crisis event that calls attention to the industry, and everybody says, "Oh, my." And it causes a lot of real economic disruption. And the typical classic effects of a crisis is really limited

availability of the types of insurance most affected by the events that are going on, very high deductibles, very low limits available, very high premiums for that amount. And in some places you have insureds who are having tremendous trouble finding any placement at all.

There follows a hard market, where prices are still high, quantities are still quite limited, and then there is a transition to a very soft market, where prices are very low relative to expected losses and availability is abundant. And the discussion of what drives this pattern, as Glenn mentioned, one of the strong views out there is that it is really caused by the ability of the industry to back losses -- capacity -- which is really capital relative to the amount demanded.

An important aspect of this theory is really that if you believe that capacity has a strong play in the cycles, you must also believe that there is some kind of market imperfection. In fact, you believe that you need that external capital, the ability to issue debt or equity really quickly to generate more capital within the industry, is expensive relative to using internal capital.

From the standpoint of what is going on in terrorism insurance, what is important about this is if you consider it a firm level, once you have internal capital more advantageous or less costly than external capital, it causes just a generic,

happy little insurer to become risk-averse. Which means that if they lose a lot of capital, there is a loss in firm value, because there are projects out there in the future that they would like to undertake which they will choose not to because they would have to go to the capital markets. And some of those projects out there just don't have that hurdle bar, while they would undertake them if they had internal capital.

The reason why that is important is not only do you have capital losses associated with these kinds of large catastrophic events, you have, as Glenn mentioned, shifts in the distribution of what's going on -- new information that comes out. And what is difficult in insurance markets is when insurers have policies in effect already out there that are not the ones that get hit by the World Trade Center or the Pentagon but that cover other, either landmarks or just other properties that are at risk for terrorism.

And what happens is that when the new information comes and when you have less capital after the event, you reevaluate your risk portfolio. And a lot of insurers will realize that they have more risk than they would have preferred, given the level of capital, given the new information about the risk. Sometimes it is just that the geography is not what you would prefer. Sometimes it is that you are really holding more than you would want. And as a result you have withdrawal from the

market, to a large extent, because that insurer already has more than it wants. Or you can even get cancellations out of this. And it is an alternative explanation for adverse selection, which I think does really well in explaining what we see after some of these crisis events.

So, now you're wondering, how does this fit with the terrorism insurance, probably. Well, it fits with terrorism insurance, quite importantly, in that the terrorist event is really one of these things where, first of all, you have a large loss of capital. You have insurers that are more risk averse, which will cause them to want a higher premium just for that. And then you have the fact that they have this large risk overhang.

That large risk overhang could be adjusted with reinsurance, but of course the same phenomena is going on with reinsurers. The capital that they have already allocated to these kinds of lines is limited and they are sitting with a lot more exposure than they had intended, and they would like to adjust that too. And the problem is you're just going to have to wait it out, short of anything else. If this market is going to adjust, it needs to have those risk overhang run off, and it has to have new entry into the field.

And that is what the price adjustment is important for. The fact that prices go way up is a return to scarce capital, and

it is a return to the ability to take on those risks. And that is fairly important in attracting new capital. And as we have seen, a lot of capital has come in for very focused risks. This is in part more flexible than it used to be in the eighties. Following the cat reinsurance crisis, there were a lot of new mechanisms, as Glenn mentioned, that helped pave the way to provide a model for how to get capacity into the industry. As a result, it is probably easier and there are fewer frictions to getting capital allocated to go for specific risks. But, as I said, one thing that is necessary to attract that capital is in fact those higher prices.

So, the first thing I would note is that, given those effects, these things are largely self-correcting. They do take time, however. And there are disruptions, very real disruptions, that occur during those periods.

My caution for government intervention on this period are several. One is that, given that this situation is temporary, really temporary, one needs to figure out a way, if you want to contribute to the market, for these level of exposures that doesn't interact or interfere with the market adjustment very much. That means that prices have to be high enough to attract the private markets, to attract the external capital, and to allow new insurers to set up facilities.

You also need, in a period when it is really, really hard, as Glenn mentioned, to figure out exactly what the expected loss on this is. Expected loss has gone up, so you expect that all the parties, regardless, should be paying more than they did before because the risk is higher than we thought it was. And the difficulty with these is in part theoretical and economic and in part empirical.

One problem with government programs has been that you have a lot of different people who are now suffering a higher cost than they thought they were going to. There is a real capital loss. You're sitting with a property that now is more expensive to insure, and should be more expensive to insure, than it was before, and there is the incentive to try to subsidize some of that. So there is a real tension there.

The one thing that one has to be very careful with is that these policies are very limited, they are very short term, they come as close as they can to mimicking what an appropriate price would be -- which would be one including the higher expected loss and one including the capital shortage, or at least a part of the capital shortage, now in. Otherwise I don't think you will get the attraction of new capital that you would like to make the market adjust quickly.

That said, there is also this second group of exposures that are really large. And given our experience with the

catastrophe reinsurance crisis, while capacity has come back in that market, and come back in quite quickly, a problem there is that it has not necessarily come in for really, really large exposures. And in that, the question is really not, should the government provide financing for it or insurance for it -- because the government, to a large extent, does; it's ex post, it's not ex ante -- but the government does step in when we have a large catastrophe and typically helps compensate people for their losses.

So the question is a little bit more subtle. The question is about whether you want to provide ex ante coverage or not and what form that ex ante coverage should take. Ideally, if you were going to do it ex ante and you really wanted to mimic the market, you would probably want to do something where you have premiums that are charged based on the expected loss, so you can get the proper incentives for these large properties to take care, and maybe they shouldn't be as expensed. Maybe some of the new projects need to be either adjusted or changed given the new market reality.

You would also like it to accumulate those funds to back the policies. The problem with this is exactly as Glenn said. If you want a temporary solution, this is not the description of a temporary solution, and that complicates the situation. In fact, the history, again, of government programs

has been one where government involvement tends to be sticky -- to stay -- and it tends to create subsidies and cross-subsidies which are not that desirable because of the incentive distortions.

Finally, I would just like to add this. Given the experience with the catastrophe reinsurance industry, there is some hope that the capital markets can step up further, not just insurers and reinsurers as we've mentioned -- there seems to be a limited capacity out there -- but the fact that there could be a market-based financial security kind of solution. You kind of want to leave room for that.

So, I guess I would say that my take on this is, for the smaller losses, I would strongly encourage very, very limited, if no, government intervention. And for the larger losses, I would really prefer a solution that leaves the market as much as possible able to work on it.

Thank you.

(Applause.)

MR. VANDOREN: Debra.

DEBRA BALLEEN,
AMERICAN INSURANCE ASSOCIATION

MS. BALLEEN: Thank you.

For those of you who might have missed the introductions, the panel was described as consisting of distinguished academics and others. And I am the other.

(Laughter.)

MS. BALLEEN: I am a representative of the American Insurance Association. We do strongly support Federal legislation, a temporary backstop for Federal terrorism reinsurance. And I agree with much of what Dr. Hubbard had to say about both the rationale and what the expectations are for the legislation.

I guess I would also say, by word of introduction, that I find myself in an awkward position, to be coming into the Cato Institute -- you are such the bastions of the free market, and I know the academics on the panel also are very free market oriented and are really here to say "Let the market work" -- and to come in and say, "I disagree; you are wrong." But I think the fact is that the market has broken down for terrorism insurance, both I think in a theoretical perspective and also in a practical perspective.

And I guess I would say that, beyond that, if we take just a couple of minutes today to look at some of the realities of the insurance market, the idea that there even is a free market for insurance and that for many lines of business it's even possible for the free market to work, that really is a myth that just doesn't work when we look at what insurance is all about from a regulatory perspective. But let me first just take a minute, somewhat repetitive of the previous speakers, and talk about the market failure that we have seen, both theoretical and real.

And when I say theoretical, I say that in the sense that immediately after September 11th, I think the insurance market -- certainly the risk perception that we all have in all aspects of our life -- was really transformed, the way that we view terrorism risk. And since insurers are in the business of assessing risk and financing risk, of course it was very profound for us, since it is the core of our business.

I think, in a nutshell, it was recognized immediately by the actuaries in our business, and then of course the CEO's who listen to the actuaries, that terrorism is not an accidental risk, it is not a quantifiable risk -- at least not as we have been able to quantify it and probably can for the foreseeable future -- it is not predictable. And these are all the

fundamental components of what makes a risk insurable from an actuarial point of view.

I think when we compare it to other extreme events, and particularly the natural catastrophe issue, there are some fundamental differences that really limit the way we can make an analogy from natural catastrophes to terrorism. There are no meaningful historical patterns. Even when Hurricane Andrew occurred, it was the largest hurricane that the U.S. had experienced, and yet we could look back over cyclical patterns of hurricanes and get some sense that it was an outlier. There were certain indicators that it might be a precursor of much larger hurricanes in the future, primarily because of development, and yet one could still look back on a large database of hurricanes, just in terms of hurricane strength, and make some predictions.

Terrorism is not random. We don't know what lurks in the mind of a terrorist and the extent to which they may try to correlate events to make things even worse.

Third, I think when we look at the World Trade Center, as terrible an event as it was both from a loss of life and a terrorism perspective, the words that I am hearing from the people in my industry right now -- the World Trade Center are building collapse, but there are also nuclear, there are also biological, there are also chemical, there are also war, in the case of at least one of our major lines of business -- suggesting

that when insurers are looking at the future, they really are worrying about events that could go well beyond the World Trade Center, both from a loss of life and a financial perspective.

And I think finally, the point I would make by way of distinguishing terrorism as we are experiencing it right now and the natural catastrophes is that the fortunate fact is that there have been no major hurricanes or earthquakes since Hurricane Andrew and the Northridge earthquake. So the system, theoretically, has had time to adjust. Some new capital has gone in. But for the most part that is really untested and we don't know what will happen if another very large natural catastrophe occurs -- and certainly that is very much the case for terrorism, given the constant threats that are before us -- for our political leaders and the media about what may come.

In terms of the market failure from a real perspective, there has been a couple of recent data points I would share with you, a recent survey undertaken by the Risk and Insurance Management Society, which is basically the risk managers of major corporations. Two-thirds of those who responded said they have no terrorism coverage. This was as of earlier this month. Eighty percent believe that their coverage is inadequate. So, those who are in the business of purchasing insurance for their companies believe very much that the market failure is real and it is something that they are really struggling to come about.

Similarly, with respect to the real estate sector, which has been very actively promoting the legislation, they too came out with some recent survey estimates and estimated that, again, as of about a week or so ago, \$15 billion worth of real estate projects in 17 States have been stalled or cancelled due to terrorism insurance problems. So, it is a significant problem. It is not a New York-Washington, D.C. problem. It really is out there over much of our country.

And to those who believe that we should let the chips fall where they will -- if it is more expensive to build projects in urban areas, we shouldn't build them or we should factor that in -- I guess there is a sense that if we respond in ways that buildings are not being built in New York because of the terrorism insurance problems, to some extent I think there are some of us who believe that the terrorists are winning. They did the right thing by targeting the World Trade Center, because they can, because of the insurance problems, and it really sort of changed the way in which we are looking at economic development here.

The second point I wanted to touch on is just the realities of insurance. So that when we use the terms "free market" and "insurance" in the same sentence we really are talking about a contradiction in terms. The fact is that insurance is one of the most heavily regulated industries in the

United States. Most of this regulation -- virtually all of this regulation -- is at the State level, which actually really complicates the issue of trying to develop a response to terrorism. Because it really is a national problem that one cannot really look at in a State-by-State way, just in terms of assessing risk and I think building capacity.

Shortly before the end of the year and in early January, the majority of State insurance regulators did approve the inclusion of terrorism exclusions in commercial property and liability policies. In fact, 45 of them did. The idea being, as I think Anne gets to in her paper, let the policyholder really bear the risk there.

The problem with that from the insurance sector is that while these were approved in 45 States, the five States that refused to approve the exclusions were California, New York, Florida, Georgia, and Texas. And together those five States account for 35 percent of the private sector commercial reinsurance market. So, when you have a 50-State system, you are really trying to drive some uniformity. If 35 percent of the market, and probably a large percent of terrorism risk as people perceive it, say, no, you can't do the exclusions, the idea of "this is the way of doing terrorism risk" really doesn't work.

Beyond the exclusions themselves, 30 States, representing 70 percent of the market, actually their fire

insurance policies are done by way of a State statute. They are called statutory fire insurance policies. They require insurance companies to cover fire that follows a lot of different kinds of events in which the underlying event may be excluded from the policy, but if it causes a fire, the insurance company has to pay.

The most common thing people think about is fire following an earthquake. But in a terrorism event, when one thinks about a plane crashing into a building, and it's really the heat of a fire that causes that building to collapse, one can really understand -- and nuclear as well -- one can really understand the potential significance of the "fire following" issue in the context of property insurance. So, again, the market does not work if the statutory fire policies are really requiring insurance companies to provide coverage for fire following a terrorism event, if in fact we think that is where the damage is likely to come.

Finally, in the workers compensation system, which is one of the largest commercial lines, workers compensation is a statutory compensation mechanism that was designed as an alternative to the tort system. It provides comprehensive medical care, wage loss benefits and death benefits for any work-related injury or death. It allows no exclusions for terrorism or, for that matter, for war. That is because of the

nature of the system. The employer cannot pull back in any way on the coverage and the insurance company is not permitted to pull back.

So, here again, we have a market that really can't respond, because the statutes that are in place really are locking insurance companies in to providing a lot more risk coverage than they are comfortable with. And I know we have had a lot of conversations with the industry in the last couple of months about workers compensation, and that is a serious problem from the point of view of really trying to assess and manage risk.

I said there were three but I have just one more. And that is the whole issue of rate regulation, which further impedes insurers' ability to collect premiums. And on several occasions, referred to as "just got to get the price," once you get the price in, really, insurance companies can handle it. But we have a lot of State insurance regulators who are saying no to the issue of price.

That is probably less an issue for the very high-end properties that may be, to some extent, outside of State rate regulation, but, for example, for workers' compensation, I know when requested to approve relatively small catastrophe loads for workers compensation insurance, virtually every State in the country said no, they wouldn't do it. They didn't think

terrorism risk was a problem in their State, and therefore they didn't think that there ought to be any inclusion of additional costs.

So, in conclusion, I guess our view is that what we have here is really an actuarial failure, a market failure and a regulatory failure, all of which have been caused by the profound changes that were brought about by 9/11 of last year. Some of them certainly will be temporary. And I think, in that sense, the Federal legislation is the right response, in the sense that it is a temporary backstop and, as the speakers have referenced, does provide for a significant private sector share before the Federal Government would kick in.

We also think that being ex ante is really important from the point of view of providing the right incentives for the development of a private insurance role. So, I would ask you all to suspend your skepticism about the role of government in insurance markets. We think that this limited role is appropriate when we look at what we are facing with respect to the market and the regulatory system that really defines insurance for terrorism today.

Thank you.

(Applause.)

MR. VANDOREN: Scott.

SCOTT HARRINGTON,
UNIVERSITY OF SOUTH CAROLINA

DR. HARRINGTON: Good afternoon. It is a pleasure to be here today. I think you are getting a good overview of different perspectives as well as similar perspectives on some parts of the problem.

My remarks are going to focus on whether any backstop by the Federal Government for terrorism risk insurance is desirable, and then whether the approaches in either the House or the Senate bills are appropriate. I am going to begin -- it's a little bit of a strawman, and I apologize for that -- but if you remember the rhetoric from much of last fall, we were hearing that little or no terrorism insurance coverage would be available and that there would be very large adverse spillovers on the availability of real estate financing on new construction and general economic activity.

Since that time, in the past 10 to 12 months, I think a calm look at what has happened would suggest that those dire predictions really have not come true, at least by and large. And let me just give you a little list of things that have happened. One is that insurers and reinsurers have raised approximately \$30 billion in new capital. There is at least another \$10 billion of capital issues pending.

The second issue is that it is true that primary insurers excluded coverage for terrorism losses where they could. A separate, stand-alone market developed very quickly for terrorism coverage, with limits initially up to approximately \$250 million. Now the brokers are reporting that it is possible in some cases to put together programs with limits of coverage up to \$1 billion. And my expectation would be that, barring another big, significant event, in which case all bets are off, that we will continue to see the limits of available coverage grow.

Now, to be sure, nuclear is excluded. And many of these programs are going to exclude biological and chemical risk. But in terms of the fire damage to things such as the World Trade Center, where we may have explosions, those things would largely be covered under these programs.

A third point is that prices are high, but the brokerage community estimates that the prices have dropped substantially since the beginning of this year. In fact, the brokers are estimating that the prices for stand-alone primary terrorism risk insurance have dropped 50 to 75 percent since early in the year. And as Professor Gron has indicated, that can indicate the adjustment to the capacity shock; it can also indicate a revision in expectations about the likelihood of future costly events.

A fourth point is that the availability of separate stand-alone reinsurance coverage is expanding.

And the fifth point, and it may be a minor point, but several catastrophe modeling firms have begun or have developed models for terrorism loss forecasting. Now, I think it is very likely they are not going to get a very good handle on the probability of additional events, but what they can do is help companies manage the risk or manage their exposure with respect to how much damage they might have from a particular type event.

Now, the bad part. To be sure, as Debra pointed out, a lot of businesses, when considering the risk of loss and the cost of coverage, are going bear. There are parties that are now bearing the risk of terrorism loss that did not bear the same risk pre-September 11th. It is also problematic to get full limits of coverage on certain property in some of our major cities, high-value, trophy-type property. Some new construction has likely been impeded, as we have heard.

But there is no evidence of any widespread reluctance of lenders to finance commercial property. In fact, lenders appear to be trying to work on methods to spread the risk that they are exposed to broadly so that they can bear it better. In short, the insurance, reinsurance and commercial lending markets have made substantial progress in digesting the events of last September.

Now, let me talk briefly about the arguments for a backstop. Argument number one is that the government has a comparative advantage in bearing this type of risk, where there is a relatively small or a very small probability of potentially enormous losses, or whether you could have many losses accumulate to enormous amounts. Their comparative advantage, in theory, is based on the notion that they don't need to accumulate large amounts of capital ex ante to make their promise to pay the claims credible, in contrast to the private sector.

A second theoretical advantage of having the government involved -- and Anne Gron has stressed the converse of this in her work with Alan Sykes and has just mentioned it -- the argument is that there may be some advantage in arranging our affairs ex ante, and having a program in place so that we will know what will be paid in the event that there is another major loss. And it also will make sure that the insurance companies are involved in settling claims if there is another major loss.

The counterargument to that, which Anne and Alan have emphasized, is that it is not obviously clear that it wouldn't be better to wait, to see if there is another major event, what the losses are, what the use of Federal funds might be appropriate for at that time, and what the competing demands for funds would be at that point. A related point, which I think is taught to us by crop insurance programs and perhaps other Federal Government

programs, is that there is no guarantee that if you commit to having the Federal Government pay for a lot of terrorism losses ex ante that they won't end up providing an enormous amount of disaster relief ex post and that there may not be anywhere near a dollar-for-dollar tradeoff in that respect.

Now, the other thing we hear about a lot -- what is another argument? The other argument is there are large externalities, when some businesses cannot undertake construction projects or when some deals do not go forward. For example, the loss of jobs, the labor may not be quickly redeployed, there is harm here that is not considered in the calculus of these developers when they go forward with the decision of whether or not to undertake a project. The problem here is that the evidence tends not to be very transparent. It is very difficult to estimate those types of costs, the costs of those spillovers, and to disentangle the effects of terrorism insurance, or the lack thereof, and other possible causes.

Now, fifth, there is a variant of my comparative advantage for the government notion, and you heard Debra talk about it a little bit. A lot of representatives of the insurance industry basically have made the point that we cannot estimate the risk of loss from terrorism. We cannot estimate it, therefore we cannot price it. If we cannot price it, we cannot insure it.

Now, the government does not appear to have any comparative advantage in estimating the risk, but it may have a comparative advantage in bearing the risk. I want to stress -- this is really a capital issue. The large risk of forecast error that arises when you don't have good data to estimate loss distributions means that companies have to put more capital up, which increases the cost of providing the coverage.

The other point I want to make is that we have to remember, this is a risk-taking industry. And if you look back especially over the last two decades, insurance companies have often provided coverage for potentially large losses where the data were very soft, where they did not have sharp estimates. Natural catastrophes, at least before the days of sophisticated cat modeling, would be one example. Another example would be product liability coverage for certain sectors of the economy. And environmental liability, satellite risk, film financing, terror risk for airlines.

There is a myth that says if you cannot get reliable data, you cannot sell insurance. And that in fact is a myth. Terrorism coverage may be quantitatively different, but it is not qualitatively different.

Now, arguments against a backstop. In a nutshell, there is a disconnect, and we are all aware of it, often between theory and practice. The theoretical comparative advantage for

government in risk bearing need not be borne out in practice. In particular, political pressure may lead to too great a subsidy if there is some sort of a backstop. And assuming that any subsidy in fact is economically efficient, you may crowd out the private sector, discourage additional capacity, discourage appropriate market adjustments. The program may produce inefficient cross-subsidies to higher-risk properties, discouraging efficient risk mitigation and increasing the vulnerability of businesses to loss.

Now, given the sort of pros and cons here, reasonable people will certainly disagree. But it seems to me that one thing is quite clear -- given the private market's responses that have occurred to date, the case for a backstop, which was not clear-cut, in my opinion, late last year, is much less compelling at this point in time. And if there is to be a backstop, it makes sense to have it follow three principles.

One principle is the program should be temporary and, as Professor Hubbard emphasized, encourage the growth of private market capacity. The second principle, and I think these go hand in hand, is that there should be a substantial layer of private sector risk bearing before any government assistance kicks in, and risk sharing between the government and the private insurers after it kicks in.

Third, intervention should scrupulously avoid any government setting of prices or approval of premium rates. And the fact that the States may interfere with that is a problem which I have written a lot about. And I definitely agree with Debra that that would be nice if that would go away.

Now, those are the principles, given these tradeoffs. What about the House and Senate bills? The House bill is legislation that is somewhat complicated. It has two triggers. One trigger is that government would pay 90 percent of losses above \$1 billion in aggregate industry losses from terrorism. There would be, however, much lower attachments for government protection for individual insurers.

In the Senate bill, the government would pay 80 percent of losses above individual insurer retentions that would likely equal roughly about 7 to 8 percent of an individual insurer's premium volume. If aggregate industry losses exceeded \$10 billion, the government's share would be 90 percent.

My opinion is pretty simple here. And that is that if any program is to be enacted, those thresholds for Federal assistance are too low. They would crowd out private sector coverage. They would impede efficient adjustments by private insurers and other businesses. So, regardless of the debates about tort limitations, in which I wholeheartedly concur with the administration and the House, a fundamental flaw with both of

these bills, in my opinion, is that the attachments for Federal assistance are too low.

What would be an alternative? And the details could be difficult here. But an alternative would be, if there is to be any program, to have the government assistance kick in at a high level of industry aggregate losses, such as -- to throw out a number -- \$10 billion. Senator Gramm proposed this type of scheme last year. It is similar to the administration's proposal for the second year of a program. With this aggregate protection which, in essence, would largely truncate the tail of this underlying loss distribution. Reinsurers and primary insurers -- but especially reinsurers -- would be able to put together deals where they could rely on the fact that if things got bad, that government money was going to start flowing in.

It wouldn't be easy, but these are the types of arrangements that many of these companies have become expert at -- spreading the risk broadly to take advantage of the economies of diversification. It would help the private sector, but there would be much less risk of crowding out the private sector and impeding efficient adjustments.

So, in conclusion, I will repeat the two things. Private insurance and reinsurance and commercial lending markets have made, and are continuing to make, substantial progress in adjusting the post-September 11th world. The case for Federal

backstop is much less compelling than it was a year ago. I don't think it was that clear-cut a year ago.

If some program is appropriate, the thresholds for government intervention should be materially higher than in either the House or the Senate bill. There are lock-in problems, as Debra mentioned. I don't think they change the conclusion that any thresholds should be materially higher.

I would also like us to at least acknowledge and keep paying some attention to the corporate tax code. The corporate tax code, because insurers and reinsurers to credibly insure catastrophic risk generally have to hold such large amounts of capital on their balance sheets, the corporate tax code significantly increases the cost of offering catastrophe coverage. Getting out of that problem or reducing that problem is very, very difficult.

It might involve fundamental tax reform, which does not appear very likely. And there are arguments against sector-specific tax reform. But I think it helps to keep in mind that one significant impediment to the private sector building capacity is the United States Tax Code, which tends to have a disproportionate effect on the conditions of supply in this particular market.

Thank you.

(Applause.)

MR. VANDOREN: First, would any of the panelists like to comment on what any of the other panelists have said?

MS. BALLEEN: I would just like to respond to one of Professor Harrington's remarks with respect to the retention level issue. Clearly, the House has much lower retention levels than the Senate bill, which in fact makes it, despite the loan feature that is sometimes talked about, it is actually a more expensive piece of legislation from the Federal Government's perspective than the Senate bill is.

We support the retention levels that are in the Senate bill. We think they are at about the right level. When you compare them to the World Trade Center losses, they are generally comparable for most major insurance companies. So, if the idea is to provide a temporary level of reinsurance that is no longer available, the idea with those retention levels is that companies would have to withstand about that type of loss before the backstop kicked in. Obviously, it is significantly higher than anything they have experienced by way of national catastrophes.

We also think that the per-company retentions that are currently in the Senate bill really are a critical component to making this work in the short term. A lot of the types of mechanisms that Scott has I think alluded to -- the idea of private pooling mechanisms -- will take a long time to put together. They probably will take several years to put together,

in terms of the experts that we have talked to. And they also create a potential mismatch between those who participate in a pooling mechanism and those who do not, in terms of how do you access the Federal share of that. Is it the first in/first out by way of Federal reimbursement? Which is very difficult, because different lines of insurance have different payout patterns.

So, again, while we are strong supporters of the private sector working it out, we happen to be strong supporters of the concept of pooling mechanisms. I think when you are looking at the short term, if you are looking to make markets functional as quickly as possible, we think the per-company retention is an essential ingredient to doing that.

DR. HUBBARD: Scott's remarks gave a two-fer, with tax reform as well, which is certainly exciting to me at least.

But on the issues here, I think there are a few points that really need to be borne out. One is this ex ante versus ex post distinction. Whenever you have large disasters, the temptation for State involvement and the actuality of that involvement is quite high. And so then the question is, what incentives do you want to arrange. And I guess I still think the ex ante approach, with its risk mitigation incentives, is better than cleaning it up after the fact.

This is not a New York City and Washington-only phenomenon. If you talk to real estate folks, both in commercial and large residential rental position around the country, this is an issue that is far outside trophy properties in the big cities. So, the notion that this is somehow something that people in New York and Washington have to worry about, and in America it is not a problem, I don't buy that.

I think the issue really is how do you buy time for the private sector. I think this came up in all of the presentations, and certainly was what the President was trying to do. Scott's principles I think are exactly the right ones. They are certainly what we believe we used in starting this debate, and I think they really call home the tension of how you build private sector capacity most effectively. And we believe that is through a temporary government backstop.

MR. VANDOREN: We will open it up for questions from the audience.

MR. FIREY: I'm Tom Firey, and I'm Managing Editor of Regulation magazine, so I'm Peter's number two guy.

I just had a question, looking at two historical examples, if that gives any insight into what we should be thinking about here. What happened in the insurance markets following the original attack on the World Trade Center in 1992? Was there a significant temporary loss of coverage? And also,

what does Israel do? I imagine terrorism insurance is an important topic there. Is that covered in any way by the state?

DR. HUBBARD: I will let the more insurance experts answer, but my general impression for Israel of course is, as with some European countries, the scale of terrorism is very different -- larger numbers of smaller-cost events as opposed to more sporadic, very large-cost events. Those are two very different terrorism distributions. The fact that we didn't see terrorism risk as an explicit line in many policies post-1993 would seem to mean that the industry did not seem to have the perspective that this was now a meaningful line going forward. But I will let the insurance experts answer.

DR. HARRINGTON: Israel definitely has a program, I think, as Glenn has correctly pointed out. They have potentially more of a frequency problem. And when I look at cross-country comparisons, I have to sort of consider the context. And I am certainly not an expert on the economy of Israel or France or Germany, but my general opinion is that they have been much more inclined to have the government intervene in private sector activity in general. And when you have something like insurance, which involves risk spreading, there is a tendency to have even more intervention in countries where it is politically popular to have the government determine prices and so on. And so I don't know to what extent that explains what happens in Israel or not.

The big events in the early nineties in the insurance industry were Hurricane Andrew and the Northridge earthquake, which completely dominated in terms of the actual losses and the impact on reinsurance markets compared to that particular event.

MS. BALLEEN: I think also, looking at the foreign markets, Great Britain actually established a program that has received a fair amount of attention here in the last year. It's called Pool Re, and it was established in response to the Northern Ireland terrorist attacks. It was limited to property insurance in certain urban markets, because that was defined as the problem. Although they are, I think, considering adding in some additional coverages.

My understanding of the Israel situation, again, in light of the particular problems they have -- and it's an unfortunate thing to have to say -- is that the program has really been geared more toward the compensation for human life as opposed to property, because that has really been the problem. So they don't have a terrorism insurance program per se, but they do provide compensation for those who lose their lives due to terrorist events.

France and Germany set up programs since 9/11 of last year. They were in some ways modeled after the Federal legislation that was pending here, because they sized them to about the same size as the \$10 billion backstop that was being

talked about here in relation to the size of their markets. The French program is in place. The German program is requiring a level of private sector participation that is still being filled out.

MR. VANDOREN: Fred.

MR. SMITH: Fred Smith, Competitive Enterprise Institute.

Prior to 9/11 the insurance industry, as was referred, had a lot of major problems. At the Federal level, the whole liability risk that you had -- you know, insurers had money in their pockets, therefore they were liable for anything, whether they covered it or not; the tax code, which distorted the ability to build up capital; and then, at the State level, over-regulation in general, and particularly rate regulation, where you couldn't price your risk accordingly and, very quickly, made a rigid, vastly limited industry.

9/11 clearly made all those things worse. But rather than address those, the Federal Government seems to rush in with an argument about infant industries, to basically say we need this adjustment period to make the industry grow, to get it back into kilter again. The history, of course, of government insurance programs -- FDIC which started at \$2,500 and now is \$200,000 and certainly does not have a strong risk management component; crop insurance; Fannie and Freddie which, according to

the Wall Street Journal today, may go under at any moment, and we're on the hook for that too; and flood insurance -- what I wonder is, rather than develop these infant industry arguments, the risk of which is they never grow up, wouldn't it be possible to go back and revisit the initial presumptions and see whether, rather than adding on a new layer of government intervention, we could strip away the layers we already have?

DR. HUBBARD: I think the examples you mention serve to make the point that Scott was making in his principles. The programs you mention were not temporary, nor did they involve significant risk-sharing on the part of the private sector. Here you have explicitly temporary programs that involve quite significant risk-sharing on the part of the private sector. So, I think there would be a strong supposition that you are more likely to get private sector capacity here than you would in the flood insurance analogy of the FDIC, where you have this permanent government program that everyone knows would impede the development of capital.

MR. VANDOREN: Anyone else on the panel?

DR. GRON: While I am not much in favor of government intervention necessarily in the insurance markets here, I would say this too, though, that it is not just the different regulatory issues that are causing insurance crises over time. You can argue maybe that the reason why you see them in the

reinsurance market is because of all the regulation in the insurance market. But the reinsurance market really is largely unregulated at an international level, and you still see problems with capacity there.

So, while I agree wholeheartedly that there are a lot of regulatory issues that make the adjustment problem worse and that really should probably have something ideally done about them, it is not the case that if you just took them away you would never find the industry with any kind of cyclic nature to it. At least that is my strong belief.

MR. VANDOREN: Yes, a question in the back.

MR. ELY: I'm Bert Ely, a banking consultant here in town.

It seems to me that there is a very serious moral hazard problem that hasn't been discussed. A terrorist attack is not a natural catastrophe. It is obviously a manmade event, and it essentially represents the failure of the Federal Government to perform perhaps the most fundamental job of government, which is to defend the country against enemy attack.

Therefore, it seems to me that when the government fails, as it clearly did on September 11th -- and that is becoming clearer by the day -- that it is the taxpayer that should get paid for these losses, because their agents, the employees of the CIA, the DOD and the FBI, failed in their job.

And then if the taxpayers paid, let's say, all losses over \$5 billion, we might have an angry group of Federal taxpayers who might insist on better performance from the Federal Government, whereas if we try to shift the loss back over to the private sector --

MR. VANDOREN: Bert, you mean like they got angry after the agriculture bill that was recently passed?

(Laughter.)

MR. ELY: They should get angry about that too.

But my point is, if we shift the losses back to the private sector, whether it's insurers or property owners, in effect, we are letting the Federal Government off the hook. And I think that that is a very serious policy mistake and introduces a moral hazard into the whole issue of dealing with terrorist attacks.

I would be interested in any comments you might have on that.

DR. HUBBARD: Let me see if I can refocus your question, Bert, or re-put it. I think what you are saying is that the taxpayers' involvement is really for the catastrophic part of this. Because I do think we believe that the private sector does have some role in providing the right incentives for things like building design, building maintenance, security

procedures, just as we would write into a whole number of P&C lines.

MR. ELY: I agree with you on the catastrophic.

DR. HUBBARD: So, basically, the role that has been put here on these programs is really for back-end involvement. That is where the big Federal dollars are. So, while not really going into your premise, I think the notion of having the taxpayers on the hook for a back-end catastrophe is what you would think of in social insurance, and that's what really is involved in these plans.

MR. VANDOREN: Yes, a question here.

MR. GLUCK: Larry Gluck, General Accounting Office.

I guess I have a list of things. The first is, with respect to Israel, it seems to me that because of the different nature of the country, they have explicitly agreed that the taxpayer should pay the cost of terrorism, even to individuals, both for property and for life. And they have explicit programs, tax collections, to do so.

Pool Re is an interesting idea that probably has a lot of appeal on a going-forward process. The problem that I had with the industry's proposal was that it was Pool Re with all the hard parts taken out. And I think that if Pool Re is ever going to get any kind of government support -- which I am not sure that

it ever will -- but if it is, they would have to put the hard parts back in.

Basically, the government does not come in, under Pool Re, until all of the pool's funds are exhausted, plus a 10-percent call on the industry capital of those insurers participating. And that was not part of the insurers' plan.

A question about securitization as a solution to this problem. Securitization has not worked very well, although hope springs eternal, for the kinds of exposures that it is currently being used for. And there are a lot of hypotheses expressed, but mostly it is because investors don't understand it. I don't know that investors will ever understand terrorism risk enough to put money into covering it.

I was interested in Scott's discussion of pricing with inadequate information as a usual part of the insurance business. And I think that is actually a correct statement in many ways. The difference, it seems to me, is that most of those examples that you use are examples where the individual risk is relatively small compared to the entire exposure that you can collect premium from. I think that is the catastrophic issue. It is the catastrophic nature of the terrorist risk that is the problem.

And then I have a question. I wasn't sure I understood you, Scott. Were you suggesting that there should only be an

aggregate trigger and not an individual company trigger? I wasn't clear.

DR. HARRINGTON: Yes.

MR. GLUCK: The problem, it seems to me, with that is that any single company has to price as if bears the entire risk.

DR. HARRINGTON: Larry, if you go back to the beginning of the discussion about what was going to happen in insurance markets, the focus was on reinsurance, the inability of reinsurers to do what they do now. The reinsurers, once they bundle together a lot of policies, they have to consider the aggregate loss distribution. And I sometimes wonder whether I have overestimated the sophistication of some of the people in the reinsurance business, but it seems to me that if they know that the aggregate loss distribution will be truncated at a certain point, or substantially truncated, that they will come up with educated guesses about the impact then on their particular portfolio, which will affect the price at which they want to do the deal at. And you have a lot of brokers out there that make their living by putting deals together, and you will find that things would develop so that you would have a lot of risk spreading underneath that aggregate attachment point.

I wholeheartedly, though, would point out -- Debra is right -- the type of thing I am proposing will have less of a short-run impact on the terrorism insurance market. My view is

that the tradeoff is a good one, because I'm worried about displacing a market that will become more vibrant over time, barring other events.

Just a quick footnote -- we haven't touched really on the war risk issue, but I think we all know that all bets are off if things change enough. I, for one, would not criticize, for example, England's policy in World War II of having government insurance on shipping. Certain things happen where the externalities get so great, the costs are so great, that we will all come to an agreement that we should have maybe even first-dollar coverage.

MR. GLUCK: And I think that is a situation that Israel is in, basically. They consider themselves to be at war. So, I concur with that. Thank you very much.

MS. BALLEEN: Can I just make a comment on Pool Re comment that you made, Larry. And for those in the audience who have not been following this legislative event quite as closely as others of us, early in the debate, the insurance industry came out with a proposal that was in fact modeled after the Pool Re approach. Larry is right that it was perhaps less harsh for the industry than Pool Re now exists. I would also argue that the insurance industry has never seen a piece of legislation enacted exactly as the insurance industry has proposed it.

I think it was the administration that was uncomfortable with the notion of really creating an entity that might sit in Treasury or some other Federal agency, the idea again that that was less likely to be temporary, and so the industry has backed off of that approach and really has been working with the administration on an approach that they have been more comfortable with. As we have been through this debate month after month, it's really surprising how many people have approached me and said, you know, that Pool Re idea was really a very good one if you look at some of the potential problems that you have under some of the scenarios, particularly the House bill, that might be resolved with the Pool Re approach.

I think it's an interesting academic exercise. It wasn't where the politics took this debate, and we have tried to stick with what was doable, keeping in mind that it has been really workable in England.

DR. HARRINGTON: I would just add with regard to Pool Re, the thing I looked at with Pool Re was, how are you going to do this without some sort of government involvement in setting the tariff, as they like to call it in Europe? And in fact, in Great Britain, there has been some controversy over time about the rates. Sometimes they argue that the rates are too high, because there have not been any terror losses lately -- and this is the public or insureds. Other times they argue that the

rates are too low. So, there would have been some politicization of this entire pricing of terrorism risk. Maybe the incentives would be okay, but I think there was a real risk there.

DR. HUBBARD: Yes, I think that was a key reason, certainly, for my opposition to Pool Re, as well as having a long-term Treasury presence, which I think is pernicious, in the sense that you are creating a constituency for a long-term program.

MR. VANDOREN: Yes, a question in the back.

MR. RUGGICH: My name is Peter Ruggich, NTV, Hungarian National TV Network.

Since I am a reporter, I like quotes, and I find many good ones in your press releases. So, I just would read two of them: Without coverage against terrorist acts, banks will not lend and it will be difficult to sell major projects, such as new pipelines, powerplants, skyscrapers.

And another one: The U.S. economy cannot possibly recover without the full availability of insurance.

To my ears, to European ears, this sounds pretty harsh. Isn't this kind of apocalyptic thinking, somewhat of an exaggeration, or is this kind of economic threat really a hardcore fact of reality? Or are we creating a psychosis here?

DR. HUBBARD: I think apoplectic is a good word. I don't know about the psychosis.

(Laughter.)

MR. MILLER: Tom Miller, from Cato.

I want to return to what Fred Smith started with, looking at the political economy of government involvement in a "temporary insurance program." The government program is kind of like a dinner guest that stays and stays and stays and becomes a long-term houseguest once it gets involved. A couple of data points for Glenn to comment on.

Rent control was a temporary measure to deal with the housing shortage in New York City during World War II. For a partial share of private sector, with a government insurance wraparound, we have the model of Medigap insurance, 80/20 percent, which tends to increase more costs upon the taxpayer-funded share of health risk as a result of the incentives in that structure. So the question is: How do we really get in briefly and ever know that we are going to get out, given all that we know about the constituencies that build up around even the beginning of such a program?

It seems that there is not an exit strategy here short of writing in a provision, as I mentioned to Scott today, that we do what we did for commercial aircraft, and just wait until AIG says they can commercially underwrite it, and then the government will get out.

DR. HUBBARD: AIG can do that.

I think you raise a very important point. Everybody wants this to be temporary. The question is, how? We believe that having two things, the sliding scale of the risk and sliding scale on the effective pricing role for the industry, was the way to do it.

You can never be sure that government does not creep in. But the examples you gave are telling, because in rent control of course, you did not have that kind of private pricing mechanism. You created immediately a constituency that would have fought tooth and nail for the reform. So, that is precisely why we wanted the private sector on the hook for perhaps even a bit more than the private sector wanted to be on the hook, but we felt that was important to keep it temporary. So, I take your point, but that was the reason for the design.

MS. BALLEEN: I think, if you look historically, there are two examples of property casualty programs that were temporary in nature. One, in addition to Great Britain during World War II, the United States had a property war insurance program that, when World War II was over, it was disbanded. So, in that instance, I guess the external events led to the lack of need for the program and, rather than keep it around, it actually went away.

There was also a riot reinsurance program that was enacted, I think around 1968-69, and it was in business for about

13 years. I think there were sort of two issues that led to its demise. One was the market came and was really able to handle that risk. The other was, politically, the Congress at that time imposed such draconian conditions on it that none of the insurance companies wanted to participate.

So, I guess our view is that we really like the need to go away, to make the program go away, as opposed to it becoming so draconian that it becomes really a contradiction in terms. But it has been done in the property casualty insurance industry, and I guess we would believe that it can be done again.

MR. VANDOREN: Yes.

MR. OSBORNE: Jack Osborne, with Sunshine.

I would like to ask about distinguishing. I know that we have said that estimating the total cost risk of terrorism is exceedingly difficult, but I wonder about whether you have a rough estimate of the percentage that would be attributable to punitive as opposed to compensatory damages. And of course that would differ drastically, depending on the type of insurance line. But, overall, is there a sense of how that would break down?

And you all may be aware that there is a mega-asbestos trial starting up in West Virginia today, and I wonder if the need to address the issue of terrorism insurance and punitive

damages in this context might not provide a platform for looking at the issue of punitive damages overall.

DR. HUBBARD: Well, it is certainly not the administration's intent to use terrorism risk insurance as a stalking horse for a tort agenda. Having said that, you have identified a tax on the economy that comes from the trial lawyers and the plaintiffs' bar, and that is something that is very important to address in public policy. We think, in the terrorism risk insurance, it is particularly important to start, because here you have the state itself on the hook.

DR. HARRINGTON: I think, with regard to the asbestosis situation, it relates to Anne Gron's comments. That whole situation, environmental and asbestos, and now with this resurgence, does create a continual drag on the capital of quite a few insurance companies. Now, it has probably altered the landscape in insurance by helping newer firms, or firms that were not around 20 years ago, to prosper at the expense of those that had this sort of overhang from this. But this new asbestos development is really quite startling.

Now, to some extent, the insurers, a lot of them, have already disgorged most of what they will have to disgorge, so now it is hitting private companies that are going into reorganization, as you know. But we ask our insurance companies to do a lot that might be, at best, arguably related to their

underlying contractual obligations. And we have to recognize that when we do that, then we make it more difficult for this sector to respond to real risks that are not endogenous, in some sense, to our own legal system and how we manage that.

MS. BALLEEN: I would agree with all of those points, and those of Dr. Hubbard as well. We certainly are not seeing this as really an entry into the broader tort reform debate.

I think, with respect to your issue on asbestos itself, the insurance industry, a large sector of the manufacturing community, is actually supporting asbestos litigation reform in Congress as well. That bill does not deal with the issue of punitive damages. I think there are issues in the asbestos arena that are very distinct from punitive damages, that really cry out for being reformed. Perhaps the Cato Institute would like to sponsor a forum on that, because you could easily spend an afternoon talking about the problems there.

We see the tort issue in terrorism legislation as being very narrowly focused on the specific set of circumstances that may surround a terrorism attack.

MR. VANDOREN: Yes, down here.

MR. HERSHEY: I'm Bob Hershey. I'm a consulting engineer.

Scott, you had mentioned that the rates for line item terrorism insurance had been going down. Did you have some

numbers on that, the cost per million dollars? And maybe, if they're going down enough, then by the time any legislation would be in place, we're already through it.

DR. HARRINGTON: What I've read, which has come from the brokerage community -- it's very ballpark information -- I know one of the major reinsurance brokers -- and I can provide you the cite on this -- pointed out that, early in the year, the so-called rate online was ranging from 1 to 5 percent. So, if you had a limit of \$100 million, the rate might go from \$1 million to \$5 million. And now they said the typical rate online was in the neighborhood of .5 percent to 2 percent. Again, that is just ballpark, without the entire distribution. And I saw this also in a report by another major broker -- comparable numbers -- so there is probably some credibility to those data.

MR. VANDOREN: Yes.

MR. PUGH: David Pugh, from the World Bank.

If you're in Outer Mongolia, you might get the \$1 billion in coverage. If you're in Washington, D.C., you cannot. And the prices have gone up in the last six months in Washington.

To comment on the Pool Re thing, I think one of the things to remember is that the U.S. insurance industry is still substantially a regional one and, if I recall correctly, had the

original Pool Re concept been in place in the U.S. when the World Trade Center attacks occurred, an insurer in Ohio that has no risks in New York would have paid \$30 million for nothing, because they don't write in New York. And that is the difficulty in trying to apply that concept, which works extremely well in Great Britain, to a country as large as the United States.

My main question is for Professor Hubbard. The thing that I don't understand is how the Federal Government would ever adjust these losses. How would they decide whose was the first \$20 million, whose was the next? There is an incentive in having 80 percent first and then 90 percent for insurers not to claim until everybody else has claimed, so that they get 90 percent of their money back rather than 80 percent. And there is an incentive for people to inflate their claims reserves. I just don't see how you would adjust the losses on the scheme as proposed.

DR. HUBBARD: Well, the scheme that is actually proposed in the legislation, as Scott said, has these company-specific limits. So, the actual legislation is more on a company-specific basis.

MR. PUGH: [Off microphone.]

DR. HUBBARD: Again, I don't think that comes up in the actual legislation, because, again, the charge is against your company's share of this proportionate -- it is based on your

share of revenues, multiplied by the aggregate loss. That is the feature of the legislation.

MR. PUGH: [Off microphone.]

DR. HUBBARD: If you are in terrorism risk, yes.

DR. HARRINGTON: I think the individual company retentions is one way of streamlining that problem. It does seem to me that with an aggregate retention of, say, \$10 billion, that there could be a system where there is an estimated reimbursement rate, which would be trued up over time as claims actually settle, which you could link the reimbursement to paid claims.

Now, I haven't thought through the possible distortions and the incentives for claim settlement in anything like that. I think I would have personally liked to see more work and more discussion of the proposal like Senator Gramm's, because then we would have had to nail down how an aggregate retention might work compared to an individual company retention.

My concern with the individual company retention is it effectively drops down the retention so that relatively small events would cause Federal monies to be paid compared to the aggregate.

MR. VANDOREN: Yes, back here.

MR. DIEFENDORFER: Bill Diefendorfer. I'm a lawyer and CEO of a very small software firm -- getting smaller by the day.

I might observe, Debra, you being the "other" that you talked about, I once saw a panel like this that had three very distinguished economists. One had a Nobel Prize to his name, and then sort of a regular person. And the regular person had a Mark Twain character -- I guess blessing -- and he observed that being an economist was one of the few embarrassments he spared his mother. So, don't be too shy about not being a distinguished academic.

(Laughter.)

MR. DIEFENDORFER: It seems like we have agreement roughly on it's a short-term problem and nobody wants the government in it for the long term. The facts I believe are that many people are going bear now. Many people are underinsured. I think the facts are also that many of those who are going bear and who are underinsured are in technical default of their lending agreements. Banks are choosing to ignore them now. If you're on the board of directors of a bank, I wouldn't be too sanguine about that.

And if you take the experience that we have had with a relatively low-level event compared to what happened at the World Trade Center, with anthrax, the buildings have been put out of commission for a length of time. Terrorists -- which is not random activities like hurricanes and earthquakes and those sorts of things -- could, without much planning and I think without a

whole lot of effort, cause a huge disruption by picking their targets, knowing people -- significant, say, hotel companies, who are going bear or are underinsured, and hitting five or six of their hotels with a chemical or a biological agent, and cause huge disruption in the financial markets, cause banks that are now holding loans that are in technical default to reconsider what they are doing and begin calling them.

And typical with Washington I believe -- and I'm not critical of anybody here -- is we have been doing this for a year now. And the President has been a great leader. There have been Republicans and Democrats who have taken this seriously and got it done, moved bills through the Congress. But it reminds me a lot of Nero fiddling while Rome burned. I think there has to be a solution to this, at least for the short term, where people can do business and they know that there is a deep pocket at the end. Unfortunately, the deep pocket for us is the Federal Government.

But my guess is, with two or three weeks left in this congressional session, we are not going to see anything, and we are exposed. I guess that is not a question but it is a comment.

DR. GRON: I actually have a comment. I appreciate your statement about being technically in default, but the statement starts with the premise that there were these rules that people wrote contracts under before, and now we have different information and the old rules should apply. And there

are things that are not part of those contracts, like you don't have to get insurance for nuclear explosions and you don't have to get insurance for acts of war. So, it is not like there is no experience, that you never take on a risk that does not have a deep pocket behind it.

I think that the starting point that all the ways that contracts used to be written and all the ways that risks were distributed before should always maintain the same. That it shouldn't be that maybe more than one thing readjusts is potentially not the best starting place that we could have. And I think, particularly given that there are other risks out there, very, very large catastrophic risks, that we are not necessarily covered for, gives some sense that maybe we can go forward without having to wait until the government moves to have a life.

MS. BALLEEN: I guess I would agree just fundamentally with your impatience, Bill, with getting this legislation done. The situation really is that there are some issues about the rate online, maybe going down for certain instances, but one of the things we really haven't even touched upon is that as more and more of these reinsurance contracts are coming up for renewal, there actually are more and more policyholders that are being displaced. So, some policyholders that were relatively comfortable at various points in the year have become displaced

as a result of the unique nature of the way that insurance policies and reinsurance policies are renewed.

Scott and I were talking before we began about how many times I've appeared on panels on this issue, and I said that every time I accept an invitation, I think it is going to be after the legislation gets enacted. And I'm telling you, the next time I'm on one of these panels, I'm going to be talking about a bill that has been enacted into law, much along the lines of those that we talked about. And we are also going to be talking about how the market can begin to step in over the long term and really deal with what is obviously a long-term risk.

MR. VANDOREN: On that note, I think we will adjourn and go upstairs for refreshments, and we will continue the discussion there. Thank you very much.

(Applause.)

(Whereupon, the Cato Institute Policy Forum concluded.)