

Insuring Against Terror?

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I. INTRODUCTION

On November 26, 2002, President George W. Bush signed the Terrorism Risk Insurance Act, one of the centerpieces of his agenda to revive the economy and mitigate the economic threat posed by terrorism.¹ The Act was designed to address an alleged economic “crisis” caused by the unwillingness of insurers to issue terrorism insurance except on prohibitively expensive terms in the wake of the World Trade Center attacks.² The Act’s proponents claimed that the unavailability of terrorism insurance not only left physical assets exposed or underinsured against terrorist acts, but also threatened to undermine the viability of capital projects that depended on access to terrorism insurance to secure bank loans.³

The Act’s solution to this problem was to create a temporary federal government reinsurance program lasting up to three years.⁴ This program will fund ninety percent of the costs, above increasing annual deductibles,

1. See Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 101(a)-(b), 116 Stat. 2322, 2322-23 (codified at 15 U.S.C.A. §§ 248, 1610, 6701 (West Supp. 2003)) (detailing the economic objectives of the Act to overcome the effects of terrorism); Elisabeth Bumiller, *Government To Cover Most Costs of Insurance Losses in Terrorism*, N.Y. TIMES, Nov. 27, 2002, at A1 (noting that the Act was one of the President’s legislative priorities).

2. See GEN. ACCOUNTING OFFICE, PUB. NO. GAO-02-472T, TERRORISM INSURANCE: RISING UNINSURED EXPOSURE TO ATTACKS HEIGHTENS POTENTIAL ECONOMIC VULNERABILITIES 3-12 (2002).

3. See JOINT ECON. COMM., 107TH CONG., ECONOMIC PERSPECTIVES ON TERRORISM INSURANCE 5-13 (Comm. Print 2002); see also *\$8 Billion Plus in Deals Affected by Terrorism Insurance Issues*, MORTGAGE BANKING, Sept. 2002, at 105 (claiming that the lack of comprehensive and affordable terrorism insurance since September 11, 2001, had killed \$3.7 billion of commercial property deals and delayed or changed the pricing of \$4.5 billion in other deals).

4. See Terrorism Risk Insurance Act §§ 101(b), 108(a). The reinsurance plan initially covers only property-casualty insurance, which is the focus of this Note. See *id.* §§ 102(12), 103(a)-(b). The Act also mandates that the Secretary of the Treasury conduct a study concerning the potential expansion of the reinsurance plan to cover group life insurance and authorizes the Secretary to expand reinsurance coverage if she deems this coverage “is not or will not be reasonably available.” See *id.* § 103(h). The implications of potential government intervention in the group life insurance market could be a paper in itself and will not be addressed extensively in this Note.

that the insurance industry may face from terrorist attacks.⁵ The Act's professed, if somewhat nebulous, goal was to ensure the "widespread availability and affordability of property and casualty insurance for terrorism risk"⁶ at "reasonable and predictable prices."⁷ President Bush spoke for many of the Act's supporters in claiming that the greater access to terrorism insurance resulting from the Act would enable "builders and investors [to] begin construction in real estate projects that have been stalled for too long, and get our hard hats back to work."⁸

This public-interest story⁹ of terrorism insurance market failure that necessitated government intervention had resonance both with politicians and with a public wrought with emotion after the World Trade Center attacks and frightened by the specter of future acts of terrorism.¹⁰ The federal government has a long history of offering subsidized insurance

5. *See id.* § 103(e).

6. *See id.* § 101(b)(1).

7. *See id.* § 101(a)(1).

8. Press Release, White House, President Signs Terrorism Insurance Act (Nov. 26, 2002), at <http://www.whitehouse.gov/news/releases/2002/11/20021126-1.html>. The President claimed that at least \$15 billion in construction projects had been delayed or cancelled because of higher premiums for property and casualty insurance, terrorism exclusions in policies, or the withdrawal of insurers from property and casualty insurance markets. *Id.*

9. Public-interest theorists posit that there is a public interest, distinct from private interests, and that government regulation is generally designed to serve the public interest. *See* STEPHEN BREYER, *REGULATION AND ITS REFORM* 15-35 (1982) (laying out public-interest rationales for government regulation); Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG., 167, 168-69 (1990); Sidney A. Shapiro, *Keeping the Baby and Throwing Out the Bathwater: Justice Breyer's Critique of Regulation*, 8 ADMIN. L.J. AM. U. 721, 721 (1995). In contrast, public-choice theorists argue that ostensibly public purposes serve as pretexts for organized interests to initiate and/or shape government regulation in order to advance private ends through state action or inaction. *See generally* Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223 (1986); Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987); Samuel Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MANAGERIAL SCI. 335 (1974); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MANAGERIAL SCI. 3 (1971). This Note seeks to further efforts to integrate lessons from both public-interest and public-choice views into coherent ways of designing public institutions that contain safeguards to limit rent-seeking and public capture. *See, e.g.*, Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 7-10 (1995) (laying out a set of procedural and substantive reforms designed to further the Clinton Administration's attempt to "reinvent government" and enhance the regulatory processes and outcomes); Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 407-08 (1990) (seeking to learn from past failures and the omnipresence of paradoxes of the regulatory state to forge more effective public institutions).

10. The House approved the Act by a majority of 227 to 193 and affirmed the subsequent conference report by a voice vote, which reflected a high level of consensus for the final product. *See* 148 CONG. REC. H8802-09 (daily ed. Nov. 14, 2002), 2002 WL 31537314. The Senate approved the Act by an overwhelming majority of 85 to 12. *See* 148 CONG. REC. S11,524-25 (daily ed. Nov. 19, 2002), 2002 WL 31600115; *see also* Adam Clymer & Janet Elder, *Poll Finds Unease on Terror Fight and Concerns About War on Iraq*, N.Y. TIMES, Sept. 8, 2002, at A1 (noting that American public opinion suggested widespread doubt that the federal government had done enough to address potential terrorist attacks).

programs, such as flood insurance, that are rife with moral hazards and have often served no one's interests save the insured beneficiaries.¹¹ In spite of this fact, the market failure story for terrorism insurance has some economic credence.¹² Insurers face difficulties in estimating both the probability of terrorist attacks and their likely magnitude.¹³ Following the World Trade Center attacks, perceptions of the probability of terrorism risks increased dramatically,¹⁴ and the short-term capacity of terrorism insurance declined significantly.¹⁵ Yet a year after the September 11, 2001 attacks, and before the Terrorism Risk Insurance Act's passage, terrorism insurance had once again become readily available for those facing small and medium risks of terrorism. Insurance premiums had begun to decrease gradually from high levels following the World Trade Center attacks.¹⁶

Nonetheless, high-risk property owners and developers of infrastructure or expensive properties in large cities, such as Chicago, New York City, and Washington, D.C., often could still not acquire terrorism insurance policies at any price.¹⁷ These high-risk parties combined with insurers to argue that government intervention was needed to overcome an alleged market failure in order to safeguard both the economy and homeland security.¹⁸

Public justifications of the Act based on the market failure story covered an equally important subtext: rent-seeking by insurers, individuals,

11. See George L. Priest, *The Government, the Market, and the Problem of Catastrophic Loss*, 12 J. RISK & UNCERTAINTY 219, 225-35 (1996) (identifying many of the problems that have plagued past programs of government-subsidized insurance against catastrophic losses).

12. See Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 536-50 (1986) (discussing the general advantages of market over government insurance provision, but arguing that "[g]overnment mitigation would, however, be appropriate if designed to alleviate imperfections that prevent markets from efficiently addressing risks and incentives").

13. See Moody's Investors Serv., CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate 3 (Mar. 1, 2002), at <http://www.nareit.com/governmentrelations/moodys.pdf>.

14. Changed risk perceptions both among the general public and the insurance industry in the wake of the World Trade Center attacks highlight the phenomenon that Cass Sunstein recently termed "probability neglect." "[W]hen intense emotions are engaged, people tend to focus on the adverse outcome, not on its likelihood," which may lead to significant distortions in both private behavior and public policy. Cass R. Sunstein, *Probability Neglect: Emotions, Worst Cases, and Law*, 112 YALE L.J. 61, 62-63 (2002).

15. See GEN. ACCOUNTING OFFICE, *supra* note 2, at 2.

16. See Lisa S. Howard, *Capacity Issues Creep into Specialty Terror Market*, NAT'L UNDERWRITER, May 6, 2002, at 20 (noting that in the seven months since September 11, 2001, "the market has stabilized, more capacity has become available, and prices have dropped"); CONSUMER FED'N OF AM., HOW THE LACK OF FEDERAL BACK UP FOR TERRORISM INSURANCE HAS AFFECTED INSURERS AND CONSUMERS: AN UPDATE 5-11 (2002), at http://www.consumerfed.org/terror_insurance_report.pdf.

17. See CONSUMER FED'N OF AM., *supra* note 16, at 5.

18. See, e.g., Press Release, Coalition To Insure Against Terrorism, CIAT Welcomes President's Call for Senate Action on Terror Insurance (Apr. 8, 2002), at http://www.insureagainstterrorism.org/news_040802.html (quoting a spokesman who argued the Act "is about jobs, economic security and homeland security").

and corporations that face high risks from terrorism attacks.¹⁹ These parties functioned as political entrepreneurs who successfully advocated the federal government's assumption of much of the economic risks posed by the threat of terrorist attacks.²⁰ Few politicians in an election year could resist jumping on the bandwagon of terrorism insurance intervention. This issue allowed politicians to demonstrate to the general public that they were addressing economic and homeland security issues, while simultaneously providing rents for their supporters.²¹

Insuring against terror may pose new challenges for both insurers and insured, but successful rent-seeking is an all-too-familiar tale in American public policymaking. What distinguishes the terrorism insurance market is not the government's decision to intervene, but the reinsurance approach that the government adopted, which provides an innovative means of limiting the effects of the rents.²² The strength of special-interest pressure made upwards redistribution almost inevitable in any government "solution." Nonetheless, this Note will demonstrate how the reinsurance

19. Rent-seeking is generally used to describe expenditures by both producer and consumer interests designed to seek "rents" or redistribution of wealth from legislative or administrative bodies. James Buchanan, Robert Tollison, and Gordon Tullock define rent-seeking as "the resource-wasting activities of individuals in seeking transfers of wealth through the aegis of the state." See James M. Buchanan et al., *Preface* to TOWARD A THEORY OF THE RENT-SEEKING SOCIETY, at ix, ix (James M. Buchanan et al. eds., 1980). Cass Sunstein defines rent-seeking as "the dissipation of wealth through efforts to redistribute resources by way of politics." CASS R. SUNSTEIN, *AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE* 70 (1990). Richard Posner frames rent-seeking as the attempt to gain a supranormal profit (a rent) without producing additional outputs. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 9-11, 37 n.3 (4th ed. 1992). For a different view of rent-seeking, see Mark Kelman, *On Democracy-Bashing: A Skeptical Look at the Theoretical and "Empirical" Practice of the Public Choice Movement*, 74 VA. L. REV. 199, 230-38 (1988) (arguing for the democratic nature and benefits of rent-seeking behavior, and criticizing the public-choice movement).

20. This rent-seeking story was below the radar screen of public debate, which focused on the alleged economic impact of terrorism insurance availability and sympathetic "poster children" of unemployed construction workers and landmarks that lacked insurance. See, e.g., Press Release, *supra* note 8.

21. See Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 CORNELL L. REV. 43, 51-52 (1988) (framing legislators as political entrepreneurs who actively seek to embrace and control issues that will maximize their electoral support while allowing them to supply rents to organized interests).

22. The U.S. reinsurance system does bear some resemblance to the British Pool Reinsurance system (Pool Re), which was formed as a response to Irish Republican Army attacks in London. The British Pool Re is a mutual reinsurance company that incorporates a national government backstop for terrorist acts. Participation is optional for all insurers. If an insurer chooses to participate in Pool Re, all of its property policies must be reinsured through Pool Re, which charges rates based on the insured property's value, its urban or rural location, and estimates of the individual properties' exposure. The reinsurance pool is funded by these charges and a three percent government levy on all property insurance in the United Kingdom. In the event of a terrorist attack the insurer is liable for the first £100,000, then all insurers are subject to a ten percent call on their annual contribution to the pool if the pool is exhausted, and after that point the remaining losses are fully covered by the British government. See William B. Bice, Comment, *British Government Reinsurance and Acts of Terrorism: The Problems of Pool Re*, 15 U. PA. J. INT'L BUS. L. 441, 448-54 (1994). As Part III will highlight, the U.S. reinsurance plan differs in significant respects.

approach is an innovation over past direct government insurance plans because of its incorporation of safeguards to limit the degree of rent-seeking and the distorting effects of government intervention.

A number of legal scholars have highlighted insurers' use of terrorism exclusions in policies issued after the World Trade Center attacks in order to avoid liability exposure.²³ The legal literature, however, has thus far largely overlooked the Terrorism Risk Insurance Act.²⁴ Law-and-economics scholars have repeatedly made arguments against government interventions in insurance markets, relying on solid empirical examples of the distorting effects of past government interventions.²⁵ A few law-and-economics scholars have applied these largely valid economic critiques of government intervention to terrorism insurance.²⁶ This Note argues that the economic case for government intervention is stronger than these critics have acknowledged, yet shows how rent-seeking drove intervention. This Note concludes that the lasting legacy of the Act is the indirect intervention that the reinsurance plan entails.

This reinsurance approach satisfies the overwhelming rent-seeking pressures, yet limits the distorting effects of intervention on private markets. The plan still contains loopholes for further rent-seeking that policymakers should seek to narrow, especially if this "temporary" program becomes effectively permanent. The use of deductibles and copayments,

23. See, e.g., Steven Plitt, *The Changing Face of Global Terrorism and a New Look of War: An Analysis of the War-Risk Exclusion in the Wake of the Anniversary of September 11, and Beyond*, 39 WILLAMETTE L. REV. 31 (2003); Gene Rappe, *The Role of Insurance in the Battle Against Terrorism*, 12 DEPAUL BUS. L.J. 351, 363-77 (2000) (arguing how existing policy exclusions prior to September 11th could be used to mitigate losses that insurers will face from future terrorist attacks); Jane Kendall, Comment, *The Incalculable Risk: How the World Trade Center Disaster Accelerated the Evolution of Insurance Terrorism Exclusions*, 36 U. RICH. L. REV. 569 (2002) (highlighting the range of policy exclusions that have developed after the World Trade Center attacks); Annemarie Sedore, Note, *War Risk Exclusions in the 21st Century: Applying War Risk Exclusions to the Attacks of September 11th*, 82 B.U. L. REV. 1041 (2002) (discussing why insurers chose not to attempt to exercise war exclusion claims for the September 11th attacks and why and how they would seek to use these exclusions to mitigate future losses).

24. This Note only reflects legal developments concerning the Terrorism Risk Insurance Act and the academic literature as of April 1, 2003.

25. See, e.g., Richard A. Epstein, *Catastrophic Responses to Catastrophic Risks*, 12 J. RISK & UNCERTAINTY 287 (1996). See generally Priest, *supra* note 11.

26. See ANNE GRON & ALAN O. SYKES, *TERRORISM AND INSURANCE MARKETS: A ROLE FOR THE GOVERNMENT AS INSURER?* (Univ. of Chi., Law & Econ. Working Paper No. 155 (2d ser.), 2002), at <http://www.law.uchicago.edu/Lawecon/index.html> (criticizing the long-term distorting effects of terrorism insurance); Saul Levmore & Kyle Logue, *Insuring Against Terrorism—and Crime* (Feb. 6, 2003), at <http://www.law.umich.edu/centersandprograms/olin/workshops.htm> (critiquing how federal government responses to the September 11th attacks, such as the reinsurance plan and the September 11th Victim Compensation Fund, may affect private expectations concerning government responses to future terrorist attacks, and assessing the implications of terrorism insurance for the possibility of broader government insurance against crime). But see Jeffrey R. Brown et al., *Federal Terrorism Risk Insurance*, 55 NAT'L TAX J. 647, 653-54 (2002) (praising the time-limited nature of the then-pending legislation and the presence of provisions to limit the crowding out effect on private insurers).

however, may serve as a model for federal insurance intervention that provides private insurers with incentives to limit the moral hazards and other rent-seeking abuses that have historically plagued direct government insurance programs.²⁷

Part II will show that there may be special justifications for intervention in the terrorism insurance market, but that rent-seeking interest groups overemphasized the “crisis” affecting terrorism insurance. This Part will analyze the special economic challenges that insurers face in estimating the probability of terrorist attacks and having the liquidity to cover the costs of catastrophic terrorist attacks. It will consider the theoretical case for the government’s assumption of at least part of the terrorism risk. This Part will also assess the extent to which both private insurers and other affected parties successfully adapted to higher perceived terrorism risk in the year between the World Trade Center attacks and the Terrorism Risk Insurance Act’s passage. While the economic case for intervention has some credence, this Part will show how politics drove government intervention. Part II will highlight how insurers and high-risk property owners successfully constructed terrorism insurance as a public rather than as an exclusively private problem to provide cover for their rent-seeking agenda. The linkage of terrorism insurance with the economic downturn and homeland security provided politicians with the perfect opportunity to address pressing issues and also award rents to special interests.

Part III will show that in spite of the Act’s genesis in rent-seeking, the design of the government reinsurance plan represents significant progress compared to direct, subsidized insurance. This innovative approach incorporates the almost inevitable upwards redistribution that subsidized government insurance entails and advances special interests far more than the general interest.²⁸ Nonetheless, the plan’s employment of market pricing by insurers limits rent-seeking. The use of copayments and deductibles reduces moral hazards and limits the degree of risk shifting to the federal government. The Note concludes that the plan’s pragmatic attempt to balance overwhelming rent-seeking pressures with economic safeguards may form a model for containing the rent-seeking and distorting effects of government intervention in a world of policymaking characterized more by political failures than by market failures.

27. See Kaplow, *supra* note 12, at 537-44 (discussing the fact that government insurance provision generally fails to remedy, and often exacerbates, moral hazards).

28. See Levine & Forrence, *supra* note 9, at 174-77 (describing general interest policies as those that would likely have secured the support of a majority of citizens if their information, organization, and transaction costs were zero, and contrasting this useful standard to the elusive ideal of the public interest).

II. THE CASE FOR GOVERNMENT INTERVENTION

A. *The Economic Challenges Facing Terrorism Insurance*

1. *How Pure Insurance Markets Work*

Before beginning a discussion of the special economic challenges posed by terrorism insurance, it is necessary to establish clearly what insurance is designed to do. This, in turn, may help to elucidate when market failures may be taking place. Insurance covers risks that are not preventable for a lower cost than the expected loss. For example, no amount of preventive measures can fully eliminate the probability of property damage from natural catastrophes. Pure insurance provision allows individuals to pay the expected value of their loss plus a premium for transaction costs up-front to limit the economic consequences of a given risk's occurrence.²⁹ Insurers eliminate the disutility of risk by pooling a given insured's risk with other risks with which it is not correlated and transforming risks individuals face into almost certain costs.³⁰

Insurers use measurement costs and transaction costs to calculate insurance premiums.³¹ Measurement costs are the product of the estimated probability of an insured risk's occurrence and the economic cost of loss if the insured risk occurs.³² Measurement costs form the primary basis for calculating insurance premiums, and their precision rests on the accuracy of the underlying information. Insurers also charge additional fees for transaction costs incurred in insurers' administration of the policies, as well as additional margins for profit.³³

The classic case of pure insurance is life insurance.³⁴ No company knows when a given individual is going to die, but actuarial tables can indicate with great precision that a person of X age and in good health has a Y percentage chance of dying. The insurance premium for a life insurance policy of Z dollars on such a person is then simply the product of Z dollars with the Y percentage chance of death, plus transaction costs.³⁵ This transaction offers literally no risks for the insurer, so long as the pool of insured individuals is adequately large and the information gathered on the individuals insured is accurate. The only reason a life insurance company

29. See George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1539 (1987).

30. See *id.* at 1540.

31. See POSNER, *supra* note 19, at 103-05.

32. See *id.*

33. See *id.*

34. See Douglas A. Kahn & Lawrence W. Waggoner, *Tax Consequences of Assigning Life Insurance—Time for Another Look*, 4 FLA. TAX REV. 381, 384-85 (1999).

35. See *id.*

would secure reinsurance under these circumstances would be to ensure liquidity in case a large number of deaths or premature withdrawals of funds occur in a short period of time.³⁶

2. *How Terrorism Insurance Differs from Insurance for Natural Catastrophes*

Terrorism insurance differs from pure insurance in two important respects that raise the possibility of lasting market failure. First, terrorism insurers suffer from a significant lack of available information to make determinations on the probability of terrorist events and, to a lesser extent, face difficulties in estimating the potential magnitude of terrorist attacks. If insurance companies significantly underestimate the risk probabilities and the potential magnitude of terrorist attacks, they may be exposed to risks well above revenues from insurance premiums. Insurers may also suffer from a lack of liquidity that may arise from the occurrence of large-scale terrorist attacks and may need to purchase reinsurance to guard against this possibility.

Many, if not most, insurance calculations necessarily entail a degree of misestimation risk because of the limits on the availability and accuracy of information. Insurers can calculate the statistical probability of a man's death with great precision.³⁷ In contrast, other risks such as the probability of a flood, hurricane, or earthquake are (in ascending order) far more difficult to predict and analogous to acts of terrorism in the scale of damages that they can cause. These misestimation risks are not diversifiable, and insurers must charge additional premiums to increase the amount of capital they are holding to cover these additional risks.³⁸

The question of the potential for market failure is whether there is a difference in degree or in kind from the misestimation risks facing insurance estimates for natural catastrophes, such that terrorism risks "require" a government solution.³⁹ Both natural and terrorist catastrophes share three basic features: They occur infrequently and unpredictably, yet they can impose huge costs when they do occur.⁴⁰

36. *See id.*

37. *See id.*

38. *See* Scott E. Harrington, *Rethinking Disaster Policy*, 23 REGULATION 40, 42 (2000).

39. The federal government has not been constrained by this approach. Political pressures have led to government insurance for any number of much more foreseeable catastrophes, such as flooding on the Mississippi River. *See, e.g.*, Flood Disaster Protection Act of 1973, Pub. L. No. 93-234, 87 Stat. 975 (codified as amended in scattered sections of 42 U.S.C.); National Flood Insurance Act of 1968, Pub. L. No. 90-448, 82 Stat. 572 (codified as amended in scattered sections of 42 U.S.C.).

40. *See* Weimin Dong et al., *A Rational Approach to Pricing of Catastrophe Insurance*, 12 J. RISK & UNCERTAINTY 201, 201 (1996).

In spite of the basic similarity, insurers may face significantly greater challenges in anticipating the risks of terrorist attacks than natural catastrophes. Unlike natural catastrophes, there are currently so few data points on the occurrence of terrorism that it is extremely difficult to calculate probabilities of a risk's occurrence and its magnitude.⁴¹ If terrorist events begin to occur with greater frequency, then over time it is conceivable that companies will be able to predict the probability of terrorist events with more accuracy.⁴² Nonetheless, the current lack of data for estimating risks may point to the potential desirability of a "short term" reduction of risk through government intervention.

The risk of natural catastrophes cannot be anticipated in an actuarial sense,⁴³ but terrorist attacks lack even the *relative* degree of predictability that many natural catastrophic events share. Terrorists often purposefully avoid attacking in patterns in order to minimize the possibility of capture and presumably to maximize terror.⁴⁴ In contrast, natural catastrophes generally follow proximate patterns, even though the incidence of a given natural event incorporates a significant degree of randomness in its timing and location (hence, the need for insurance). For example, earthquakes track fault lines, and hurricanes generally affect the same parts of the Gulf of Mexico or the South Atlantic Coast. Even the "Big One" earthquake, which may have devastating economic consequences, is a geographically limited threat to the West Coast and is unlikely to affect Peoria, Illinois or Nashville, Tennessee. One can argue that terrorist attacks may follow the same patterns over time of only threatening urban centers or infrastructure targets. As the Oklahoma City bombing and the Unabomber remind us, however, the number of potential terrorist targets may be far larger than areas exposed to a given type of natural catastrophe.

Insurers can estimate with some precision the scope of threats posed by natural catastrophes through tools such as hazard-risk maps and historical estimates of the probability of an event's occurrence and levels of compensation likely to result.⁴⁵ These probabilistic tools have limits, as the high uncertainty of the timing of the "Big One" earthquake in California suggests. The accuracy of the information detailing the probability and magnitude of this mega-event is doubtful. This type of catastrophic event

41. See Moody's Investors Serv., *supra* note 13, at 3.

42. See, e.g., Gordon Woo, Quantifying Insurance Terrorism Risk 11-16 (Feb. 1, 2002), at <http://www.nber.org/~confer/2002/insw02/woo.pdf> (suggesting how it may be possible to use data points of terrorist attacks and near misses to parametrize loss-severity distributions and to make estimates of the annual loss-exceedance probability, yet acknowledging the need for the extensive use of subjective risk-probability estimations).

43. See Dong et al., *supra* note 40, at 201.

44. See Moody's Investors Serv., *supra* note 13, at 3.

45. Sophisticated insurance industry software programs can incorporate these data into probabilities for a given locality and structure that is being insured. See, e.g., CDS Bus. Mapping, Risk Maps, at http://www.cdsc.com/risk_maps.htm (last visited Feb. 26, 2003).

may pose similar difficulties for probability estimations and insurer liquidity as large-scale terrorist attacks.⁴⁶

Some insurance models have been introduced for terrorism insurance that claim to incorporate probabilities and potential severities for a full range of terrorist attacks.⁴⁷ The efficacy of these models is dubious, however, for the reasons mentioned above. The sparse number of actual and attempted terrorist attacks in the United States provides few data points for models to consider.

Insurers can determine risks on a relative basis by imposing higher premiums for prominent landmarks and for urban over suburban or for suburban over rural properties.⁴⁸ Insurers may also begin to demand additional information on the concentration of employees, building locations, security precautions, and catastrophe plans to begin making case-by-case determinations of risk exposure. But insurers currently lack the tools to determine what the baseline of the probabilistic risk of terrorist attacks should be. For this reason, the potential for misestimation for terrorism insurance may expose insurers to higher risks than other forms of insurance.

3. *The Potential Liquidity Problems in the Case of Full-Scale Catastrophes*

Another compelling argument for intervention is the liquidity concern facing the insurance and reinsurance industry in the event of future catastrophic terrorist attacks.⁴⁹ Only the federal government has the deep (and theoretically unlimited) pockets through its taxing powers to endure the financial shocks of the most severe catastrophic events.⁵⁰ This is one of

46. Only seventeen percent of Californians have earthquake insurance. This figure is down from twenty-eight percent before the Northridge earthquake in 1994, primarily because of the very high premiums. See Vicki Lankarge, *The Big One Will Devastate Californians' Financial Foundation* (June 19, 2002), at <http://www.insure.com/states/ca/home/quakefinances.html>. The fact that government reinsurance for terrorism insurance has been enacted, while government provision for earthquake insurance has not, even when the implications of both have some similar characteristics, suggests the importance of organized interest groups in setting political agendas. See *infra* Section II.C.

47. See, e.g., Ara C. Trembly, *Terrorism Modeling Grows for Insurers in Post-9/11 Era*, NAT'L UNDERWRITER, Oct. 14, 2002, at 12 (describing four different terrorism risk-estimation models that employ game theory to estimate risk exposure); Press Release, AIR Worldwide Corp., *Terrorism Risk Insurance Act Poses New Underwriting Challenges for Insurers* (Nov. 21, 2002), at <http://www.insurance-portal.com/112202.htm> (discussing the AIR Fully Probabilistic Terrorism Loss Estimation Model).

48. See Moody's Investors Serv., *supra* note 13, at 6-7.

49. See, e.g., JOINT ECON. COMM., *supra* note 3, at 1-5; AM. ACAD. OF ACTUARIES, *TERRORISM INSURANCE COVERAGE IN THE AFTERMATH OF SEPTEMBER 11TH*, at 2-5 (2002); GEN. ACCOUNTING OFFICE, *supra* note 2, at 3-7.

50. Warren Buffett, head of Berkshire Hathaway and its subsidiary General Reinsurance, summarized the conventional wisdom of insurance industry participants:

the historic rationales for war and nuclear exclusions. Otherwise, a single nuclear warhead hitting New York City could easily destroy the liquidity and viability of the insurance industry. This fact creates a substantial moral hazard if people widely assume that the federal government will offer assistance in response to a catastrophic event because of liquidity concerns for insurers and incentives to intervene for reelection-seeking politicians. Individuals at risk may then have little incentive to buy insurance in the first place or may take fewer precautions against damage from attacks.

In the case of the attacks on the World Trade Center, this faith was partly vindicated through the \$20 billion the federal government granted to New York City.⁵¹ In this case, insurers had the liquidity to meet their obligations of \$30 to \$40 billion dollars (or \$19.5 to \$26 billion after taking into account the thirty-five percent federal tax write-offs).⁵² The multi-million dollar settlements awarded to all victims, many of whom had large life insurance policies and who were disproportionately affluent, suggest that reelection-seeking politicians will bend over backward to intervene in high-profile catastrophes.⁵³

To the extent that insurance premiums reflect popular assumptions of ex post government intervention, then ex ante government intervention may have little effect beyond increasing the overall subsidies to insured parties. This effect may be partly offset by a decreased probability of state compensation in the event of low-scale attacks, which may encourage more people to buy policies. Nonetheless, as Part III will discuss, fixing the timing and nature of government intervention may place some limits on rents for insurers (and the insured). It may partly reduce post-catastrophe rent-seeking (at least in the context of small-scale attacks) by allowing politicians and opponents to point to the framework for compensation under the reinsurance plan.⁵⁴

Terrorist attacks may raise significant liquidity issues, but it is important to emphasize that they do not appear necessarily different from those posed by natural catastrophes. Events over the past decade

Under a "close-to-worst-case" scenario, which could conceivably involve \$1 trillion of damage, the insurance industry would be destroyed unless it manages in some manner to dramatically limit its assumption of terrorism risks. Only the U.S. Government has the resources to absorb such a blow. If it is unwilling to do so on a prospective basis, the general citizenry must bear its own risks and count on the Government to come to its rescue after a disaster occurs.

Stephanie K. Jones, *Terrorism Insurance and Home Security*, INS. J. (Apr. 15, 2002), at <http://www.insurancejournal.com/magazines/west/2002/04/15/partingshots/18881.htm>.

51. See Carl Hulse, *Congress at Ground Zero: The Special Assembly*, N.Y. TIMES, Sept. 7, 2002, at B1.

52. CONSUMER FED'N OF AM., *supra* note 16, at 4.

53. Cf. Peter H. Schuck, *Equity for All Victims*, N.Y. TIMES, Dec. 19, 2001, at A35 (highlighting the disconnect between generous federal compensation for victims of the World Trade Center attacks and the government's lack of compensation for victims of other torts).

54. See *infra* Subsection III.B.4.

highlighted how natural catastrophes may pose equally significant threats to the liquidity of insurers and reinsurers. The combined \$40.2 billion in devastation inflicted by Hurricane Andrew in 1992 and the Northridge earthquake in 1994 approximated the cost to insurers and reinsurers of the World Trade Center attacks.⁵⁵ Both of these events served as a chilling reminder that property-casualty insurers must anticipate insurance claims of upwards of \$50 to \$100 billion from even a single natural disaster, let alone a terrorist threat.⁵⁶ The threat of the “Big One” earthquake in California dramatizes the point that natural catastrophes may pose liquidity threats equal to those posed by terrorist threats, and that the insurance industry may be totally unprepared to handle either type of truly catastrophic event.

Terrorism risks may raise distinctive challenges in accurately predicting risks, although the predictability challenges posed by the “Big One” may somewhat undercut this claim. Nonetheless, the significant dangers of misestimation of terrorism risks and the liquidity risks in the case of catastrophic attacks suggest a plausible story of at least the potential for market failure. In theory, these concerns alone might be sufficient to justify some form of government intervention at least in the short term. In spite of this fact, as Part III will suggest, the potential distorting effects of government intervention would likely militate against intervention on economic grounds alone.

4. *The Economic Case for Government Intervention To Reduce Terrorism Risks*

An additional economic justification for intervention is that the government’s assumption of at least some degree of terrorism risk facing private parties may be both efficient and desirable. The close interplay between the federal government’s foreign policy decisions and the existence of terrorist threats suggests that the federal government may be at least partly responsible for “creating” many of the risks posed by terrorism. The federal government may also be in a better position than private

55. See Reinsurance Ass’n of Am., *The Reinsurance Market: The Impact of the September 11th Terrorism Catastrophe* (Apr. 24, 2002), at http://www.raanet.org/policyupdate/terrorism/terrorism_qa.pdf; see also STANDARD & POOR’S, *GLOBAL REINSURANCE HIGHLIGHTS 2002: GEARING UP FOR 2003*, at 8 (2002), at <http://www.standardandpoors.com/europe/deutsch/content/resourcecenter/pdf/0211GlobalReinsuranceHighlights2002.pdf> (noting the best estimates are that the reinsurance industry will face \$31 billion in claims from the World Trade Center attacks).

56. In contrast, catastrophic losses totaled a mere \$34.6 billion for the entire period between 1949 and 1991. Kenneth A. Froot & Paul G.J. O’Connell, *The Pricing of U.S. Catastrophe Reinsurance*, in *THE FINANCING OF CATASTROPHE RISK* 195, 195 (Kenneth A. Froot ed., 1999); see also Kenneth A. Froot, *Introduction to THE FINANCING OF CATASTROPHE RISK*, *supra*, at 1.

insurers to mitigate or prevent risks of terrorism,⁵⁷ and, therefore, it may be more efficient for the government to internalize these costs.

One of the federal government's current priorities is homeland security. The federal government's intelligence and enforcement network may place the government in a better position than private insurers to estimate the probability of terrorist attacks and to act to reduce their probability of realization and impact through preemptive enforcement actions. The federal government is spending billions of dollars accumulating counterterrorist information that it may not be able to disclose to private insurers because of national security concerns.⁵⁸ At least in theory, a government agency could use this information to make more accurate risk estimates than its private counterparts. Greater risk sharing between the government and private insurers could also increase incentives for the government to disclose more counterterrorist information to insurers. Regardless of this point, the experience of private insurers in estimating risks in other areas and the insulation of private insurers from rent-seeking may offset any government information advantage, as Section III.C will argue. The federal government's monopoly in setting American foreign policy, however, vests it with both the power to address terrorist threats and, arguably, a responsibility to address the costs of terrorist attacks that may be by-products of foreign policy decisions.

The rationale that the federal government should internalize the costs from terrorist attacks that its foreign policies may have helped to provoke has remained unspoken amidst debates on terrorism insurance. This is understandable, for politicians would be very unwise to raise this argument during a time of war. America's close relationship with Israel, defense of its interests in the Middle East, and active engagement in other parts of the world may be completely justified. Nonetheless, U.S. foreign policy decisions have aroused the ire of terrorist groups. International relations scholars may attempt to explain away terrorism based on factors relating to poverty, religious fundamentalism, alienation, social backwardness, or any other number of causes.⁵⁹ The most immediate spark for terrorist attacks

57. Americans, especially political leaders, tend to regard terrorism as unprovoked actions that have no correlation with American policies. See, e.g., L. Paul Bremer, III, *A New Strategy for the New Face of Terrorism*, NAT'L INT., Thanksgiving 2001, at 23, 24-25 (arguing that "[n]othing America can say or do, short of ceasing to exist, will satisfy these terrorists"). No one can ever truly attempt to justify recourse to terrorism, but terrorists frequently justify their actions as responses to U.S. foreign policies, especially in the Middle East.

58. The federal government budgeted \$40 billion for counterterrorism efforts for 2002 alone. See Sheryl Gay Stolberg, *Germ Defense Said To Cost Nearly Twice Bush Proposal*, N.Y. TIMES, Nov. 29, 2001, at B8. This sum likely produces classified terrorist risk information that dwarfs terrorism risk information that private insurers can legally acquire at any price.

59. See, e.g., Adam Garfinkle, *The Impossible Imperative? Conjuring Arab Democracy*, NAT'L INT., Fall 2002, at 156 (arguing that poverty and disinformation in the Arab world form the foundations for terrorism).

against the United States, however, is likely to be a combination of America's global political and economic predominance and particular foreign policy decisions.

At the same time, the private sector often benefits from the federal government's domestic and foreign policies. As a result, one could argue that private parties should accept the bitter with the sweet. They should therefore assume these terrorism risks as the price for the benefits of living and operating within the United States, regardless of whether the threats are by-products of American foreign policy decisions.

It is also doubtful whether the internalization of the costs of risks created by terrorism would have any appreciable effect on foreign or domestic policies. The self-interest of politicians in reelection already provides sufficient incentive for them to appear attentive to homeland security issues, especially when our nation is absorbed with the threat of terrorism. Politicians are also much more likely to respond to powerful special-interest groups on foreign policies and may be indifferent as to whether the federal government absorbs these costs. Nonetheless, the role of U.S. foreign policy decisions in provoking terrorism and the federal government's powers to detect and prevent terrorist acts may make allocation of risk to the government more efficient than allocating it to affected private parties.

B. *The Potential for a "Free Market" Solution*⁶⁰

A limited theoretical case exists for government intervention to mitigate the effects of the special challenges posed by terrorism insurance and to offset the role that foreign policy decisions play in provoking terrorist attacks. This Section will move from the theoretical case for intervention to examine the economic viability of the terrorism insurance market during the year between the World Trade Center attacks and the enactment of the Terrorism Risk Insurance Act. The economic story told by the Act's proponents was one of paralysis facing insurers, businesses, and other property owners without government intervention on terrorism insurance, a theme that Section II.C will discuss in depth. This alleged insurance "crisis" had little substance in reality, yet served as a successful rent-seeking tactic to gain the support of politicians and the general public.

60. The term "free market" is somewhat of a misnomer as the insurance industry is subject to significant regulation at the state level as discussed *infra* Subsection III.B.3. The reference here merely signifies the fact that market forces attempted to work out many of the challenges facing the industry on their own from September 11, 2001 through November 26, 2002.

1. *The Short-Term Capacity Crisis*

Much of the alleged crisis was attributable to short-term capacity shortages caused in part by insurers' perceived overexposure to risks that preceded, yet were accentuated by, the World Trade Center attacks.⁶¹ The year-long lag time between the World Trade Center attacks on September 11, 2001, and the enactment of the Terrorism Risk Insurance Act on November 26, 2002, provided time to test the potential of market forces to address the challenges of terrorism insurance on their own.⁶²

The lower capacity in the aftermath of the World Trade Center attacks was far from unprecedented and mirrored the pattern insurers followed after the almost \$45 billion in combined damages from Hurricane Andrew and the Northridge earthquake in 1992 and 1994, respectively. In the short term, insurers and reinsurers decreased capacity at the very time demand increased because of greater perceived needs for protection due to their desire to preserve their liquidity. The World Trade Center attacks radically changed the risk perceptions of insurers. Their terrorism risk probability calculations and premium prices reflected these new concerns. Premium increases—to the extent that terrorism insurance itself was available in the immediate aftermath of 9/11—doubled or even quadrupled.⁶³ As insurers recovered from these setbacks and perceptions of risk decreased, both insurance capacity increased and premiums for property and casualty insurance moderately decreased.⁶⁴

2. *The Narrowing of the "Crisis" to a Problem Mainly Facing Those with High Risks*

In the immediate aftermath of the World Trade Center attacks, a plausible economic case existed for short-term government subsidies to temper widespread dislocation costs. These expenditures could have functioned as Keynesian stabilizers to smooth out the effects of the terrorist attacks and the economic downturn.⁶⁵ A reduced appetite for risk by insurers had led to the widespread introduction of terrorism exclusions and

61. See GRON & SYKES, *supra* note 26, at 2-3, 7-13 (reviewing factors that led to past insurance "crises").

62. A partisan battle over tort reform and the inclusion of reinsurance coverage for punitive damages held up enactment of the Act for almost a full year, which provided the opportunity to see how market forces would address the challenges of terrorism insurance. See Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 107, 116 Stat. 2322, 2335 (codified at 15 U.S.C.A. §§ 248, 1610, 6701 (West Supp. 2003)) (noting the exclusion of punitive damages from the government's reinsurance coverage).

63. Moody's Investors Serv., *supra* note 13, at 4.

64. CONSUMER FED'N OF AM., *supra* note 16, at 5-10.

65. See GEN. ACCOUNTING OFFICE, *supra* note 2, at 3-7.

limited coverage availability.⁶⁶ This problem was magnified by the reluctance of reinsurers to continue to offer reinsurance because of the greater risks, coupled with the expiration of seventy percent of reinsurance treaties on January 1, 2002.⁶⁷

Since bank loans generally require full insurance protection, this situation created economic dislocation in the short term and posed a dilemma for a wide range of construction companies, building owners, and corporations. Building projects that were planned with the risk assumptions prior to September 11, 2001 became less economically attractive and potentially not viable because of new perceptions of risk from terrorist attacks.⁶⁸ In the short term, this dislocation undoubtedly resulted in cancelled projects and fewer construction jobs,⁶⁹ although the concurrent economic downturn may have played an even larger role in these outcomes. In the long term, changed risk perceptions may shift the focus of construction away from high-risk areas, although in some cases this investment shift may be a politically unviable option as the following Section will highlight.

Government intervention to temper the effects of this type of short-term dislocation might have made some economic sense and served as a form of Keynesian stabilizer to help smooth out the effects of recession.⁷⁰ In the year between the attacks and the Act, however, the availability of insurance increased, and the behavior of affected actors began to change to accommodate the new circumstances during the interim.⁷¹

For example, bank lenders began to adapt to more limited access to terrorism insurance by waiving these provisions in exchange for higher loan rates to offset greater risks assumed by the bank.⁷² It is also likely developers began to change plans to reflect the changed risks and to build in new locations or at lower heights within high-risk locations, although this point is more difficult to prove. During the year between the attacks and the

66. *See id.* at 5 (noting that terrorism insurance exclusions allowing insurers to offer property-casualty insurance without terrorism coverage had been approved by forty-five state insurance commissioners between September 11, 2001 and February 2002).

67. Moody's Investors Serv., *supra* note 13, at 4.

68. *See, e.g., \$8 Billion Plus in Deals Affected by Terrorism Insurance Issues*, *supra* note 3, at 105.

69. Notwithstanding this fact, estimates of \$15 billion in cancelled construction projects and the laying off of over 300,000 building professionals may be more a product of an economic downturn than the product of a lack of terrorism insurance. *See* Press Release, *supra* note 8.

70. Further intervention on this front may have been unnecessary as unemployed workers already received unemployment assistance and tax write-offs for the costs of cancelled projects. Both serve as forms of Keynesian automatic stabilizers. *See* JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* 27-34 (1st ed. 1964) (setting forth the basic framework for the Keynesian theory of economics).

71. CONSUMER FED'N OF AM., *supra* note 16, at 5-10.

72. *See* Daniel Hays, *Bankers End Up Plugging Terrorism Insurance Gap*, NAT'L UNDERWRITER, Feb. 18, 2002, at 5; *see also* GRON & SYKES, *supra* note 26, at 3-4 (correctly anticipating this development).

enactment of the Terrorism Risk Insurance Act, terrorism insurance availability increased and prices substantially decreased for those with small and moderate terrorism insurance risks.⁷³ Terrorism insurance premiums remained substantially higher than before the World Trade Center attacks. The high prices and the prospect of government relief may have depressed the number and extent of policies purchased by those with small and medium risks. The bottom line was that those facing small or moderate terrorism risks, however, once again largely enjoyed access to terrorism insurance.⁷⁴

After the short-term capacity shortage slowly ended, only a narrow pool of high-risk parties confronted a “crisis” of terrorism insurance availability.⁷⁵ This group included owners of prominent properties in major cities, primarily Chicago, New York City, and Washington, D.C.,⁷⁶ and others with infrastructure or other properties that were perceived as high-risk targets. Owners of trophy buildings in high-profile locations and buildings of more than fifty stories faced severe difficulties in acquiring any terrorism insurance at all, or above minimal coverage of seventy-five to one hundred million dollars.⁷⁷

The economically efficient outcome would be for these high-risk parties to pay higher premiums to banks for loans and to fully internalize these risks if they cannot acquire terrorism insurance. The long-term effect of changed perceptions of risks may be to create greater incentives for new buildings to be located in different places such as suburbs, rather than cities, or to be built at lower heights in cities to reduce terrorism risk exposure.

Existing skyscrapers without terrorism insurance may pose a greater problem. They may be attractive targets for terrorists, and their owners in extreme cases may not be able to internalize terrorism risks. If terrorism risks prove prohibitively high in probability and intensity (and the United States is nowhere near this point) and preventive measures are limited, it is conceivable that few people would want to lease space in skyscrapers and that these buildings would cease to be economically viable. This possibility is an extremely remote prospect given the current level of terrorist threats, and local and national pride would obviously preclude even considering the demolition of these landmarks.

73. See Howard, *supra* note 16, at 20 (noting that in the seven months since September 11, 2001, “the market has stabilized, more capacity has become available, and prices have dropped” and that those seeking policies could find availability of up to \$1 billion in terrorism insurance coverage, albeit at very high prices that reflect the estimated risks).

74. CONSUMER FED’N OF AM., *supra* note 16, at 5-10.

75. For example, as of April 2002, terrorism insurance was required for high-risk parties representing only ten percent of the dollar amount of loans extended by commercial banks. See Fed. Reserve Bd., Senior Loan Officer Opinion Survey on Bank Lending Practices (Apr. 2002), at <http://www.federalreserve.gov/boarddocs/SnLoanSurvey/200205/default.htm>.

76. CONSUMER FED’N OF AM., *supra* note 16, at 5.

77. Moody’s Investors Serv., *supra* note 13, at 4-5.

The ongoing economic viability of skyscrapers absent terrorism insurance is certainly plausible. U.S. cities have faced some threat of nuclear attack from the Soviet Union (and now Russia) since the U.S.S.R.'s first atomic test in 1949. In spite of the fact that insurers have routinely excluded nuclear attack and war coverage,⁷⁸ the construction of new skyscrapers and the maintenance of old skyscrapers continued throughout the hottest points of the Cold War. Regardless of their ability to internalize terrorism risks, high-risk parties possessed more than sufficient incentives to lobby for the government to assume much of the cost of these risks, as the following Section will discuss.

C. *The Political Impetus for Government Intervention*

The economic concerns are only one part of the story of government intervention. Even if the "free market" approach of allowing insurance markets and private parties to adjust to terrorism risks on their own appeared a viable and appealing solution, policy decisions rarely, if ever, occur in a political vacuum. In the present case, the rent-seeking incentives of high-risk private actors and reelection motives of politicians combined to ensure that politics would play a far larger role in the decision to intervene than the more modest underlying economic concerns.

1. *The Incentives for the Formation of a Political Coalition To Lobby for Intervention*

The drama of the World Trade Center attacks created an opportunity for the parties most at risk to act as political entrepreneurs in marketing the unavailability of terrorism insurance as a "crisis" that demanded a federal solution.⁷⁹ As discussed in the previous Section, following a transitional period, most property owners could purchase terrorism insurance, albeit at higher prices. A relatively small but defined group of high-risk, large-scale property owners either could not acquire terrorism insurance at all, or only at prohibitively expensive prices. Insurers shared a common interest with high-risk property holders in shifting the dangers of their misestimation of terrorist risk probabilities and liquidity concerns to the federal government.⁸⁰ This context presented a classic case of a concentrated group united by a common interest that possessed the incentives and means to

78. See Rappe, *supra* note 23, at 363-65.

79. See Hulse, *supra* note 51 (noting the twenty billion dollars allocated by Congress for relief for the World Trade Center attacks to New York City alone).

80. See Albert Warson, *The Terrorism Insurance Impasse*, MORTGAGE BANKING, May 2002, at 76, 78-83.

organize to seek rents whose costs would be borne by a diffuse group of taxpayers.⁸¹

Any coalition building for rent-seeking entails significant organizational and coordination costs.⁸² Nonetheless, the scale of rents potentially at stake in government terrorism insurance intervention provided sufficient incentives to unite an impressive alliance of insurer, construction, manufacturing, real estate, and other business associations under an umbrella advocacy group, the Coalition to Insure Against Terrorism.⁸³ Other groups supported the plan, but the Coalition spearheaded public debate on a government reinsurance plan.⁸⁴ Each of these groups stood to gain rents from shifting the costs of terrorism risks onto the shoulders of the federal government. The broad nature of the coalition gave the appearance (however illusory) of credence to their claims that they were speaking in the interest of the economy, yet clearly gave the campaigners economic muscle and political influence to secure their objectives. The public record is largely silent as to why the Coalition to Insure Against Terror embraced an approach of seeking government reinsurance. One might imagine that businesses would have preferred the predictability of the direct provision of insurance by the government and the possibility of exerting direct pressure on such an authority to fix lower rates and more favorable terms.⁸⁵

Nonetheless, Part III will discuss how the reinsurance plan serves as a political and economic compromise whose use of market pricing by private insurers and copayments and deductibles limits the distorting effects of government intervention and the degree of implicit subsidies. This “backstop” approach may have been easier to “sell” to the public as either a cover for rent-seeking objectives or means to gain wider support because of the plan’s built-in constraints. Even if the latter effect of built-in constraints of the plan are what makes the Terrorism Risk Insurance Act notable, the

81. See Saul Levmore, *Coalitions and Quakes: Disaster Relief and Its Prevention*, 3 U. CHI. L. SCH. ROUNDTABLE 1, 1-3 (1996) (describing how catastrophes affecting discrete groups are the most likely to result in groups organizing and receiving government-sponsored relief).

82. See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 43-52 (1971) (showing how small, defined groups are the most likely to overcome the transaction costs and free-rider problems entailed in organizing collective action); Macey, *supra* note 21, at 46-51 (arguing that small, defined groups are best able to identify information costs and organizational costs to secure rents).

83. The members of the Coalition to Insure Against Terrorism make up a veritable “who’s who” of associations representing groups that may be affected by terrorist attacks. Warson, *supra* note 80, at 78; see also Joint Letter from Steve Bartlett, President of the Financial Services Roundtable, and Edward C. Sullivan, President of the Building and Construction Trades Department of the AFL-CIO, to President George W. Bush (Feb. 20, 2002), at <http://www.fsround.org/PDFs/FSR-BCTPOTUS.pdf> (detailing cooperation between businesses and construction-related labor unions on the issue).

84. See Warson, *supra* note 80, at 78-80.

85. See *infra* Subsection III.C.1 (comparing the different incentives created under reinsurance with direct government provision plans).

reinsurance plan as safety net story fits well with the economic story of crisis that the Act's proponents told.

2. *The Significance of Public-Problem Construction and Poster Children*

Advocates had an economic story of crisis to bring the issue of terrorism insurance to the forefront of the public agenda. In the wake of the World Trade Center attacks, they argued that the insurance industry lacked both the capacity and willingness to insure terrorism risks.⁸⁶ Proponents claimed that the remaining terrorism insurance being offered was inherently inadequate in its scope and coverage and prohibitively expensive.⁸⁷ They highlighted alleged economic effects of the insurance unavailability on the construction industry and on other businesses in deepening the current economic downturn.⁸⁸ Advocates painted a specter of a larger economic threat posed by widespread uninsured losses from future catastrophic attacks.

They crystallized this message of crisis for the general public and politicians through using poster children to appeal to popular compassion, such as construction workers who were allegedly unemployed because their constructor employers could not secure terrorism insurance.⁸⁹ They pointed to famous landmarks that were vulnerable to attack and the owners of which were similarly unable to acquire or afford terrorism insurance to appeal to national pride. They also highlighted the lack of terrorism insurance for infrastructure, such as airports or malls, in order to plug into popular fears about terrorism.⁹⁰ Economically, these claims were weak because trophy building owners and others at risk should have simply internalized terrorism risks if market forces had determined no premium would be sufficient. Nonetheless, the power of the advocates' economic story helped to transform potentially economically losing arguments into political winners.

86. See, e.g., Press Release, Coalition To Insure Against Terrorism, Policyholders Launch Coalition To Seek Passage of Terrorism Insurance Plan (Feb. 13, 2002), at http://www.insureagainstterrorism.org/news_021302.html.

87. See, e.g., Coalition To Insure Against Terror, February 26 Letter to the Senate Leadership Urging Senate Passage of a Terrorism Insurance Bill (Feb. 26, 2002), at http://www.insureagainstterrorism.org/facts_itr022602.html.

88. See, e.g., Press Release, *supra* note 18 (quoting a spokesman who argued that the Act "is about jobs, economic security and homeland security").

89. See George W. Bush, Remarks by the President to Business Leaders (Apr. 8, 2002), at <http://www.whitehouse.gov/news/releases/2002/04/20020408-17.html> (highlighting anecdotal examples of building projects that could have created thousands of construction jobs in Nevada and Chicago but had been abandoned or postponed allegedly because of an inability to acquire terrorism insurance).

90. See, e.g., Press Release, *supra* note 18.

Advocates implicitly appreciated the fact that a bald story of rent-seeking for affluent high-risk parties was unlikely to gain political traction or pass a general interest test. Instead, they framed the availability and affordability of terrorism insurance as an issue of fairness affecting all potential property-casualty policyholders, not just the plan's advocates who themselves stood to gain the most from government reinsurance.

Advocates effectively intertwined the issue of terrorism insurance with the health of the economy at large and homeland security.⁹¹ This shrewd tactic raised the prominence of the issue during a time of economic recession and high concerns for homeland security, while simultaneously obfuscating advocates' primary motives of rent-seeking. This strategy built popular support. Just as importantly, it provided slack as well as a pretext for politicians both to demonstrate their efforts to deal with threats from terrorism and to supply cloaked rents for political contributors.⁹² As Part III will discuss, the particular form of government intervention through reinsurance for all terrorism insurance, rather than targeted direct subsidies or tax expenditures, reinforced the obfuscation of upwards redistribution that the plan entails. This fact allowed both advocates and politicians to argue that the Act created "a backstop, not a bailout" for the insurance industry.⁹³ This distinction provided cover for advocates' rent-seeking ends and the politicians who supported them.

3. *Agenda Setting by Greasing the Wheels of Congress*

The federal government was the primary focus of public and private lobbying activities. While insurance regulation almost exclusively occurs at the state level,⁹⁴ the federal government was the one party with the deep pockets to meet the rent-seeking needs of insurers and high-risk property owners. This point was especially true during a time when states were facing their own budget crises because of the economic downturn.⁹⁵

91. See, e.g., Coalition To Insure Against Terrorism, *supra* note 87.

92. Slack is an idea laid out in Joseph P. Kalt & Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279, 282-84 (1984), which shows how principal-agent relationships between voters and their representatives necessarily entail "slack" through which representatives fail to act in accordance with, and may shirk, voters' desires. See also Levine & Forrence, *supra* note 9, at 174 (using the concept of slack to develop a theory of when general-interest or special-interest legislation or regulation will occur and/or persist). In this case, the economic story told by the Act's advocates created greater slack for politicians to indulge the rent-seeking desires of their political contributors.

93. *The Terrorism Risk Protection Act: Hearing on H.R. 3210 Before the House Rules Comm.*, 107th Cong., 2001 WL 1518590 (2001) [hereinafter *Hearing*] (statement of Michael G. Oxley, Chairman, House Committee on Financial Services).

94. See McCarran-Ferguson Act, 15 U.S.C. § 1011 (2000) (establishing state regulatory responsibility for insurance notwithstanding the Commerce Clause). The states' regulatory roles will be discussed in depth in Subsection III.B.3.

95. See Dale Russakoff & Mike Allen, *Governors' Meeting Verges on Partisan Warfare*, WASH. POST, Feb. 24, 2003, at A5 (noting that states face budget deficits of \$30 billion in 2003).

State insurance commissioners eagerly embraced the push for the federal government to address terrorism risks through a reinsurance plan.⁹⁶ Many states had their own mini-reinsurance plans in the form of state guarantee funds for insurers that partly pooled risks among insurers by allowing state insurance commissioners to impose fees on solvent insurers to assist insurers facing liquidity problems.⁹⁷ Healthy insurers' efforts to minimize participation in state guarantee funds, however, greatly limited the efficacy of these funds as liquidity-increasing devices.⁹⁸

The reinsurance plan enabled state regulators and legislators to shift responsibility for the problem and the pressures for action from rent-seekers toward the federal government. This approach allowed the federal government to foot the bill for subsidizing insurers and high-risk property owners, while preserving state regulatory oversight over the insurance industry (and the potential contributions for state politicians that this control brings). Regardless of the degree to which state insurance commissioners functioned as truly independent regulators or were captured by the insurance industry, state leaders stood to gain by shifting responsibility for terrorism risks to the federal government.

Advocates of the reinsurance plan pursued a multilayered strategy of private congressional lobbying, campaign contributions, and public appeals to build political support. During the first six months of 2002 alone, the insurance industry spent \$33.6 million on lobbying Congress and the President with the Terrorism Risk Insurance Act at the top of its agenda.⁹⁹ Insurers complemented lobbying with direct financial contributions during the 2001-2002 election cycle of approximately \$7.7 million to Republicans and \$4.2 million to Democrats.¹⁰⁰ The disproportionate support for the Republicans reflects Republican control of the White House and the House of Representatives, yet these contributions appeared high enough to attract

and \$82 billion in 2004, and that states are seeking to lay blame for this situation on the federal government and to gain new federal subsidies).

96. See Press Release, NAIC Outlines Principles for Federal Role in Terrorism Insurance Coverage (Oct. 26, 2001), at <http://www.naic.org/pressroom/releases/>.

97. See James G. Bohn & Brian J. Hall, *The Costs of Insurance Company Failures*, in *THE ECONOMICS OF PROPERTY-CASUALTY INSURANCE* 139 (David F. Bradford ed., 1998); Bernard E. Epton & Roger A. Bixby, *Insurance Guarantee Funds: A Reassessment*, 25 *DEPAUL L. REV.* 227, 228-35 (1976).

98. See Bohn & Hall, *supra* note 97, at 139-40.

99. See Political Money Line, *Lobbying Expenditures Surged in First Six Months of 2002*, at <http://www.tray.com/cgi-win/indexhtml.exe?MBF=2002mylobby> (last visited Apr. 1, 2003). Property-casualty insurers had the most to gain through government reinsurance that immediately applied to them. The Terrorism Risk Insurance Act builds in the possibility of the plan's extension to life insurers as well, giving the entire insurance industry a tremendous interest in its enactment. See Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 103(h), (i), 116 Stat. 2322, 2332 (codified at 15 U.S.C.A. §§ 248, 1610, 6701 (West Supp. 2003)).

100. See Political Money Line, *2001-2002 Election Cycle*, at http://www.tray.com/cgi-win/x_ee.exe?DoFn=02F (last visited Apr. 1, 2003) (laying out Federal Election Commission data as of March 5, 2003).

the attention of both reelection-seeking politicians and political parties. These numbers do not include the countless millions additionally spent in federal lobbying and campaign contributions by business associations and other high-risk property holders who stood to gain large rents from government intervention.

Academics have proven that agenda setting can be more important than substantive support for a policy in ensuring its enactment vis-à-vis other alternatives.¹⁰¹ Insurers and other advocates sought to ensure that terrorism insurance would be at the forefront of the congressional agenda through focusing lobbying and campaign contributions on the members of the Senate Banking Committee and House Committee on Financial Services, the committees responsible for agenda setting on insurance industry issues. For example, during the 2001-2002 election cycle the insurance industry gave \$113,300 and was the third largest contributor to Michael G. Oxley, chairman of the House Committee on Financial Services.¹⁰² The insurance industry gave more than \$1.5 million in campaign contributions to Financial Services Committee members.¹⁰³ Finance, insurance, and real estate PACs combined to give more than \$6.5 million to members of the Financial Services Committee.¹⁰⁴ The insurance industry's contributions to the Banking Committee members similarly sought to ensure that terrorism insurance remained high on the Senate's agenda.¹⁰⁵

101. See generally Michael E. Levine & Charles R. Plott, *Agenda Influence and Its Implications*, 63 VA. L. REV. 561 (1977) (discussing the importance of agenda setting in shaping legislative outcomes); Charles R. Plott & Michael E. Levine, *A Model of Agenda Influence on Committee Decisions*, 68 AM. ECON. REV. 146 (1978) (showing how it is possible to map different democratic outcomes based on differences in the division of outcomes into voting packages, the order of presenting them, and the voting methods used to adopt them). See also KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1963) (laying out Arrow's Theorem, which establishes that there is no way to aggregate preferences that is both democratic and consistent and therefore suggests that, given any set of voter preferences, any democratic method for aggregating these preferences will be inconsistent and can lead to inconsistent outcomes).

102. Open Secrets, Michael G. Oxley: 2002 Politician Profile, at <http://www.opensecrets.org/politicians/indus.asp?cid=N00003736&cycle=2002> (last visited Apr. 1, 2003) (laying out Federal Election Commission data as of March 5, 2003).

103. Open Secrets, Top Industries Giving to Committee Members, at <http://www.opensecrets.org/cmteprofiles/indus.asp?CmtelD=H05&Cmte=HFIN&CongNo=107&Chamber=H> (last visited Apr. 1, 2003) (laying out Federal Election Commission data as of March 5, 2003).

104. *Id.*

105. Open Secrets, Senate Banking, Housing, and Urban Affairs Committee: Member Money, at <http://www.opensecrets.org/cmteprofiles/profiles.asp?CmtelD=S06&Cmte=SBAN&CongNo=107&Chamber=S&Indus=F09> (last visited Apr. 1, 2003). Contributions to Committee Chairman Paul Sarbanes are comparatively low from all sources during this period as he faced only nominal reelection opposition, but his campaign contributions from insurers appear proportionately the same as from other major industries.

4. *Incentives for Reelection-Minded Politicians*

No smoking gun links money to agenda setting and votes by congressmen, yet reelection-minded politicians had every incentive to push for government intervention on the issue of terrorism insurance.¹⁰⁶ Not only did fund-raising contributions provide incentives for paybacks in agenda setting and votes, but terrorism was also the issue of the day in popular minds during an election year.¹⁰⁷ Politicians of every stripe seeking reelection wanted to have their name at the forefront of enhancing homeland security. Advocates' public campaigns effectively interlinked the need for terrorism insurance with homeland security and the economic downturn.¹⁰⁸ This fact allowed politicians to claim that they were addressing both concerns, while simultaneously providing a cover for fulfilling the rent-seeking needs of their campaign contributors.¹⁰⁹

The additional advantage for politicians was that the combination of the World Trade Center attacks and the Bush tax cut had ended a period of relative budgetary restraint, especially for addressing terrorist concerns. The particular proposal of government reinsurance that politicians focused on had the additional appeal of not entailing any government expenditures until the occurrence of terrorist attacks. And if and when that support kicked in, it would provide an opportunity for politicians to trumpet their success in having guaranteed that individuals had the opportunity to be insured and that insurers had the liquidity to meet obligations from terrorist attacks.

The formation of a powerful coalition of insurers and high-risk parties, their effective campaign to interlink terrorism insurance with economic and homeland security concerns, and politicians' incentives to demonstrate that they were addressing economic and homeland security issues all combined to make government intervention virtually inevitable. Given the strong pressures for government intervention, Part III will argue that the reinsurance plan compares favorably to past federal government insurance intervention and the primary alternative of direct government provision.

106. Cf. 148 CONG. REC. S11,524 (daily ed. Nov. 19, 2002), 2002 WL 31600115 (recording the opposition of Senator Phil Gramm of Texas to the Act). Senator Gramm's autonomy to oppose the Act may have been shaped by his imminent retirement.

107. Stanley B. Greenberg, *What Voters Want*, N.Y. TIMES, Aug. 5, 2002, at A15.

108. See, e.g., Warson, *supra* note 80, at 85 (quoting a Coalition to Insure Against Terror spokesman, who stated that "[i]t is more than a little unsettling to note that roadways, public facilities, office complexes, stadiums and crucial elements of infrastructure that are part of our daily lives are not adequately insured against terrorist attack.... The implications are staggering.").

109. See Macey, *supra* note 21, at 51-52 (framing legislators as political entrepreneurs who actively seek to embrace and control issues that will maximize their electoral support while allowing them to supply rents to organized interests).

III. ASSESSING THE TERRORISM RISK INSURANCE ACT OF 2002

A. *An Overview of the Provisions of the Terrorism Risk Insurance Act*

The Terrorism Risk Insurance Act created a temporary federal government reinsurance program the professed goal of which is to protect consumers by ensuring the “widespread availability and affordability of property and casualty insurance for terrorism risk” at “reasonable and predictable prices.”¹¹⁰ This federal reinsurance program of up to three years mandates that all commercial property and casualty insurance providers offer terrorism insurance.¹¹¹ The Act creates a federal backstop of reinsurance, yet seeks to preserve the role of market forces in setting premiums.¹¹² The Act claims to seek to mitigate disruptions in the terrorism insurance market in the short term and thereby to give insurers space in which to develop the systems, mechanisms, and products necessary to sustain a private terrorism insurance market in the long term.¹¹³

1. *Ninety Percent Reinsurance Coverage Above Insurer Deductibles*

The Act has four main features. First, the Act commits the federal government to pay insurers 90% of annual losses from terrorist acts above insurer deductibles, until industry-wide losses equal \$100 billion annually. Federal reinsurance compensation begins only after insurance companies have paid out substantial deductibles based on direct earned premiums.¹¹⁴ Compensation for terrorist attacks occurs only for recognized attacks that inflict at least \$5 million of damage.¹¹⁵ The Act requires individual insurers to cover losses for acts of terrorism equal to 1% of direct earned premiums in 2002, 7% in 2003, 10% in 2004, and 15% in 2005.¹¹⁶ After individual insurers meet their deductibles, the federal government will pay 90% of losses, up to \$100 billion in losses. If losses exceed \$100 billion, then

110. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 101(a)(1)-(b)(1), 116 Stat. 2322, 2324 (codified at 15 U.S.C.A. §§ 248, 1610, 6701 (West Supp. 2003)).

111. *Id.* §§ 102(6), 103(a). The Act explicitly excludes health insurance, designated federally backed insurance programs, medical malpractice, and personal lines of insurance and reinsurance. *Id.* § 102(12)(B). The Treasury Secretary has discretion to expand the program to group life insurers if it proves successful and she determines that the need exists. The Secretary must also conduct a study on the impact of terrorist attacks on the availability of other lines of insurance. *Id.* § 103(h)-(i).

112. *Id.* § 101(b).

113. *Id.*

114. Direct earned premiums are the aggregate of premiums paid to insurance companies by individuals and corporations for property and casualty insurance protection. *Id.* §§ 102(4), 103(e)(7).

115. *Id.* § 102(1)(B)(ii).

116. *Id.* § 102(7). These deductibles are termed “marketplace aggregate retention.” *Id.* § 103(e)(6).

Congress must consider whether and on what terms the federal government will provide further compensation.¹¹⁷

2. *Mandatory and Discretionary Recoupment of Government Compensation*

Second, the Treasury Department has both mandatory and discretionary provisions for recouping the compensation paid by the federal government for terrorist attacks.¹¹⁸ If the insurance industry's total uncompensated losses from terrorist attacks (the aggregate of insurance companies' deductibles plus the 10% copayments) are less than \$10 billion in 2003, \$12.5 billion in 2004, or \$15 billion in 2005, then the Treasury Secretary must recoup all government funds.¹¹⁹ The formula is that the Treasury Department must recoup the difference between \$10 billion in 2003, \$12.5 billion in 2004, or \$15 billion in 2005 and the aggregate of insurers' uncompensated losses for each year, until the government recovers all federal compensation.¹²⁰ If the aggregate of all insurers' uncompensated losses from terrorist attacks exceeds \$10 billion in 2003, \$12.5 billion in 2004, or \$15 billion in 2005, then no mandatory recoupment applies for that year.¹²¹

The Treasury Secretary has discretion with regard to the timing for recouping these funds.¹²² She must, however, order insurers on an industry-wide basis to collect an annual surcharge of up to 3% of premiums on all property-casualty policyholders until the amount of mandatory recoupment is met.¹²³ In turn, these insurers must remit these monies to the federal government.¹²⁴ The Act allows the Treasury Secretary to fix lower percentages for smaller commercial and rural areas and different lines of insurance, so that types of property at greater risk face a higher percentage of any surcharge.¹²⁵

These provisions for mandatory recoupment are relatively minor compared to the Secretary's expansive discretionary recoupment powers. The Act vests the Treasury Secretary with the discretion to order the recoupment of all government compensation above the mandatory recoupment amount.¹²⁶ Exercise of this theoretical power is highly unlikely,

117. *Id.* § 103(e)(2)-(3).

118. *Id.* § 103(e)(7).

119. *Id.* § 103(e)(7)(A)-(C).

120. *Id.*

121. *Id.* § 103(e)(7)(B).

122. *Id.* § 103(e)(8) (granting the Treasury Secretary wide discretion in determining the timing for recoupment of government funds).

123. *Id.* § 103(e)(8)(C).

124. *Id.* § 103(e)(7).

125. *Id.* § 103(e)(8)(D).

126. *Id.* § 103(e)(7)(D).

in light of political pressures from reelection-seeking politicians and rent-seeking beneficiaries in times of catastrophe. The Secretary must make her decision based on considerations of the cost of this program to the taxpayer, the economic conditions in the insurance industry, the affordability of property-casualty insurance, and any other condition she deems appropriate.¹²⁷ The Act is silent on whether the Treasury Secretary should favor concerns of fiscal responsibility, the overall economy, or the affordability of property-casualty insurance in exercising this power.¹²⁸

3. *“Temporary” Mandate for Insurers To Offer Terrorism Insurance*

Third, the quid pro quo for this safety net is a federal mandate that insurance companies make available terrorism insurance for the next two years, which can be extended by the Treasury Secretary for a third year until December 31, 2005.¹²⁹ The Act nullifies all terrorism exclusions in existing policies.¹³⁰ It requires that insurers offer terrorism insurance with terms, amounts, and other coverage limitations materially similar to those that apply to other protected property and casualty losses.¹³¹ What the term “materially similar” means is left open-ended.¹³² This fact gives insurance companies discretion to estimate the risk of terrorist attacks and to charge a price that reflects their risk estimates, however high.¹³³ For the first year of price setting for terrorism insurance, state regulators may not oversee pricing decisions in advance and may only regulate prices if they appear abusive.¹³⁴

4. *Policyholders’ Right Not To Pay the Additional Premium and To Reject Coverage*

Fourth, the Act requires insurance companies to disclose to present and future policyholders the premium charged for terrorism insurance and the federal share of coverage for terrorism losses.¹³⁵ The Act mandates that insurers separately tabulate the cost of terrorism insurance coverage from

127. *Id.*

128. *Id.*

129. *Id.* § 103(c)(2).

130. *Id.* § 105.

131. *Id.* § 103(c)(1)(B).

132. *Id.* § 103(c)(1).

133. *Id.*

134. *Id.* § 106(a)(2)(B).

135. The Treasury Department has recognized the National Association of Insurance Commissioners’ Model Forms for disclosure of premiums for terrorism insurance as a “safe harbor” that satisfies the statute’s requirements. See Treasury Dep’t, Interim Guidance Concerning New Statutory Disclosure and Mandatory Availability Requirements of the Terrorism Risk Insurance Act of 2002 (Dec. 3, 2002), at <http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/interimguide.pdf>.

the overall insurance premium. This approach is designed to heighten transparency and to encourage prospective policyholders to compare premiums, so that market forces will help to keep premiums affordable.

Present policyholders will have ninety days to choose to accept or reject the terrorism insurance coverage offered by their insurers. If present or future policyholders choose to reject the additional premium for terrorism insurance, they will not receive federal protections. Insurance companies will then be able to reinstate their terrorism exclusions. New purchasers of property-casualty insurance will have the option to pay a separate premium for terrorism insurance or to accept the terrorism exclusions that insurers may impose if they decline to pay the premium.

B. *The Potential Shortcomings of the Act*

From an economic perspective, almost any form of government intervention to limit private terrorism risks is going to result in upwards redistribution and have distorting effects on private insurance markets.¹³⁶ Given that rent-seeking and political concerns are driving federal action on terrorism insurance, the economic choice is one between lesser evils in terms of the effects of government intervention. This Section will focus on four potential shortcomings facing the Act: moral hazards for the insured, adverse selection because of insurers' mandate to offer terrorism insurance, challenges facing the integration of a federal reinsurance system with state regulatory regimes, and moral hazards created by the possibility of ex post relief to the uninsured or underinsured.

1. *The Moral Hazards for the Insured*

The reinsurance plan created by the Act represents a political and economic compromise. Its use of copayments and deductibles limits, yet far from eliminates, moral hazards. For obvious reasons, the ideal for beneficiaries of government insurance would be to foist all risks on the federal government, an approach that may have highly distorting effects on actors' behavior. The reinsurance plan shifts much of the risks of catastrophic terrorism attacks to the government's shoulders. Therefore, the plan partly reduces the incentives for private firms to monitor the use of preventive measures by insured parties and/or to employ loss-sharing devices.¹³⁷ By definition any government insurance subsidy is going to

136. See Epstein, *supra* note 25, at 299-300 (arguing that any government intervention aimed at reducing the effects of catastrophic risks is likely to cause more harm than allowing the market to address the dislocations that catastrophes cause).

137. See Harrington, *supra* note 38, at 41.

create moral hazards by reducing incentives for preventive measures.¹³⁸ This potential moral hazard is severe when dealing with flood insurance or crop insurance where the payoff from exposure to the trigger event of flood or crop damage may far exceed the gains from the adoption of effective prevention measures by the insured.¹³⁹

In contrast, moral hazards appear less significant in the context of terrorism insurance, but are present nonetheless. Three main factors would at least partially limit moral hazards with regard to terrorism exposure. Insured parties would still be concerned about the severe risks to human life posed by terrorist threats, face risks of continued exposure to uncompensated punitive damages for negligence if they fail to adopt precautions,¹⁴⁰ and may incur reputational costs if they do not adopt a modicum of preventive measures.

The existence of a federal insurance subsidy, however, still introduces significant moral hazards for insurers and policyholders. Decreased risks are likely to enhance incentives for both insurers and insured to embrace greater risk-seeking behavior. In the context of terrorist threats, this may entail lower-priced terrorism insurance effectively subsidizing the construction of more investments that are exposed to higher risks, such as skyscrapers that may offer appealing terrorist targets. In spite of this potentially distorting effect, Section III.C will discuss how a virtue of the Act is that it preserves some incentives for insurers and insured to take preventive measures and to continue to internalize some of the risk exposure from their actions.

2. *The Unavoidability of Adverse Selection Problems*

Moral hazards for the insured are a concern under the Act, but on its face adverse selection appears to be a larger and more pervasive problem. The mandate that private insurers offer terrorism insurance for property-casualty policyholders without a corresponding purchase requirement, for either policyholders or property owners more broadly, may expose both the federal government and insurers to significant adverse selection problems. Some degree of adverse selection is almost unavoidable in any scheme for

138. See DARIUS LAKDAWALLA & GEORGE ZANJANI, INSURANCE, SELF-PROTECTION, AND THE ECONOMICS OF TERRORISM 1-2, 9-13 (Nat'l Bureau of Econ. Research, Working Paper No. 9215, 2002), at <http://papers.nber.org/papers/w9215.pdf> (showing both how government insurance subsidies in general, and subsidized terrorism insurance in particular, will reduce incentives for self-protection measures).

139. See Priest, *supra* note 11, at 224-25 (noting that federal crop insurance policyholders systematically earn more in years in which their crops are damaged because they receive federal compensation).

140. See POSNER, *supra* note 19, at 209 (describing the role of punitive damages and liability rules as risk-regulation devices).

subsidized insurance, so the question is to what extent the plan limits this potential. If private insurers faced no requirement to offer terrorism insurance to a given party, they could guard against adverse selection by utilizing proxies of geography, type of asset, and case-by-case assessments of risk to decide whether to offer policies. Under the Act, insurers must offer terrorism insurance coverage. Insurers' control of risk probability estimates and pricing, however, may allow them to use both proxies and case-by-case analysis to impose costs sufficiently high to compel prospective high-risk policyholders to internalize much of these risks.

The potential for adverse selection may also be much less in the context of terrorism insurance than in many other areas of insurance. When facing other risks, a given individual may enjoy an asymmetry of knowledge vis-à-vis insurers. For example, a policyholder may have knowledge about a genetic condition to which insurers may not be privy. It is unclear that there is a significant asymmetry between private insurers and the insured in terms of their ability to anticipate exposure to terrorism risks.

The insured parties will know more accurately than insurers what preventive measures they are taking. Part of the economic rationale (and an underlying assumption) for government reinsurance in the first place, however, is that the misestimation risks for terrorism insurance premium calculations are quite high. Individual policyholders are likely to have even less idea of these probabilities than are private insurers. Given private insurers' experience in making case-by-case assessments, they are also likely to have advantages in mitigating adverse selection problems compared to a federal agency.

3. *The Challenges of Integrating Federal Reinsurance with State Regulatory Regimes*

The Act creates a hybrid system in which the federal government oversees administration of the reinsurance plan, insurers set prices for terrorism insurance, and state regulators continue to regulate the prices of insurers.¹⁴¹ The decision to leave regulatory oversight of insurers in the hands of state insurance commissioners appears to be a product of political expediency, rather than an affirmation of the superior efficacy of state regulation of the insurance industry. Congressional committees have begun to consider the possibility of creating an optional federal charter system for the insurance industry,¹⁴² and the question of expanded federal regulation

141. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 106, 116 Stat. 2322, 2334 (codified at 15 U.S.C.A. §§ 248, 1610, 6701 (West Supp. 2003)).

142. See generally *Insurance Regulation and Competition for the 21st Century: Hearings Before the House Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises*, 107th Cong. (June 4, 11, 18, 2002), at <http://commdocs.house.gov/committees/>

over the insurance industry may divide both Congress and the insurance industry for many years to come. Proponents of the reinsurance plan wisely sidestepped this controversy to secure passage of the Act, and upheld the longstanding federal policy of deferring to state-level regulation of the insurance industry.¹⁴³ The Treasury Secretary and Attorney General do possess the sole ability to certify the occurrence of a terrorist attack that triggers reinsurance compensation,¹⁴⁴ and the Treasury Secretary oversees the administration of the reinsurance program.¹⁴⁵

It is far from obvious that the interests of state regulators will converge with those of the federal government. The Act appears to assume, however, that these interests will overlap and that oversight by states will assist the federal government's ends. The Act's professed (if somewhat nebulous) goal was to ensure the "widespread availability and affordability of property and casualty insurance for terrorism risk"¹⁴⁶ at "reasonable and predictable prices."¹⁴⁷ To that end, the Act mandates that insurers offer terrorism insurance on materially similar terms and amounts, and with similar coverage limitations, as apply to other protected property and casualty losses.¹⁴⁸ What the term "materially similar" means is left open-ended.¹⁴⁹

In the short term, the Act limits oversight of terrorism insurance prices by individual states in order to allow insurers to bypass any prior state approval requirements for terrorism insurance prices until December 31, 2003.¹⁵⁰ This provision appears designed to ensure that the transition to offering terrorism insurance under the reinsurance plan is not delayed. In the long run, however, the plan leaves oversight of insurers in the hands of the states. This fact means that the states alone must resolve what "materially similar" terms or "reasonable and predictable" prices are, or else simply ignore this implicit federal mandate. Given the lack of enforcement provisions at the federal level or an explicit mandate for state regulators to pursue these ends, it may be that Congress was content to give lip service to somewhat unrealistic objectives, while implicitly attempting to shift responsibility for achieving these goals to insurers and state regulators.

bank/hba80131.000/hba80131_0.HTM (discussing state efforts to reform insurance regulation and arguments for the creation of an optional federal charter regime).

143. McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (2000) (vesting insurance regulation in states).

144. Terrorism Risk Insurance Act § 102(1).

145. *Id.* § 104.

146. *Id.* § 101(b)(1).

147. *Id.* § 101(a)(1).

148. *Id.* § 103(c)(1)(B).

149. *Id.* § 103(c)(1).

150. *Id.* § 106(a)(2)(B).

The insurance industry is heavily regulated at the state level.¹⁵¹ Some states such as Illinois have “open competition” rules that largely allow the market to set prices.¹⁵² In others, state insurance commissioners must approve insurance prices in advance or have the right to reject prices for a set period of time after they are submitted to regulators.¹⁵³ In these states, rate regulatory approval processes provide insurance commissioners with the means to monitor insurance companies to make sure that insurers are complying with the Act’s requirements of offering coverage on materially similar terms as other coverage. The offices of state insurance commissioners have, however, historically been targets for rent-seeking and regulatory capture of state agencies by insurers.¹⁵⁴ This fact means that capture at the state level may help to distort or undercut some of the Act’s agenda.

A degree of state regulator divergence from federal goals or even state agency capture may not necessarily be all bad, at least in the following limited sense. The Act’s professed goals appear mere aspirations. This point is suggested by the fact that what constitutes reasonable and predictable prices is left undefined by the Act. It is also far from clear what “materially similar” terms would entail as the very nature of insurance calculations presupposes many assumptions specific to a given risk. As detailed earlier, terrorism risks entail significantly different types of challenges than other risks, and, therefore, insurers could sidestep these requirements by positing different assumptions.

State rate-regulation review processes may provide slack for insurers to pursue this end and to thereby circumvent these requirements of the Act. Even if state insurance commissioners actively tried to uphold the Act’s stated objectives, it is far from clear that this goal would be an economically desirable end. One of the advantages of vesting pricing decisions in the hands of insurers is to give insurers the flexibility to gauge the risks more accurately and, therefore, to temper the distorting effects of the implicit reinsurance subsidies. Attempts by state regulators to force insurers to offer policies on materially similar terms or to have “reasonable and predictable” rates might undercut this more important objective.

The second potential problem posed by regulatory capture is more troubling. The capture of a state insurance commissioner’s office may provide insurers with cover to retain many of the implicit subsidies that the Act creates. State insurance commissioners often face nebulous state

151. See KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 95-132 (3d ed. 2000).

152. See ILL. DEP’T OF INS., *ANNUAL REPORT TO THE ILLINOIS GENERAL ASSEMBLY ON INSURANCE COST CONTAINMENT* (1999), at <http://www.ins.state.il.us/Reports/ccreport/ccreport99.htm#IV>.

153. See ABRAHAM, *supra* note 151, at 109-16.

154. *Id.* at 114-15.

mandates of ensuring reasonable rates of return for insurers while containing costs for insurers. This fact, combined with the inherent ambiguities of risk probability calculations by insurers, may provide slack for state regulators to pass on rents to insurers by sanctioning higher prices than private markets would have generated. Since state insurance commissioners possess exclusive power to approve pricing decisions for their jurisdiction, they could attempt to facilitate price collusion among insurers through rate regulation. This problem has been historically hard to prove and could lead to the significant retention of rents by insurers. Since consumers may only see decreasing prices and not the lower prices that competitive markets would have created, the partial retention of rents by insurers may be too opaque to provoke a political backlash.

At the same time, this danger is tempered by the transparency of terrorism insurance prices since the Act mandates that insurers list the price for this coverage separately. The existence of fifty state regimes may also check this rent retention. Consumer watchdog groups or the media may highlight significant divergences in terrorism pricing across states to indicate potential agency capture by insurers. The salience of terrorism insurance may make reelection-seeking politicians unwilling to risk potential political backlashes by letting insurers siphon off too much of the implicit rents.

In spite of state rate regulation, the insurance industry has many features of a competitive industry in which no single firm or set of dominant firms can determine industry output. State entry conditions and pricing oversight form some barriers to entry,¹⁵⁵ yet the industry consists of a large number of competing firms with moderate concentration.¹⁵⁶ This fact combined with the possibility for great variation in insurers' estimates of terrorism risk probabilities may create downward price pressures on regulators and the industry.

Partial implementation of the Act by state regulation poses potential shortcomings. Creating another federal bureaucracy to monitor insurers directly or the state regulators who oversee insurers, however, was both politically unviable and likely to create more problems than it would solve. While there is a danger that insurers may retain some of the implicit

155. The two primary barriers to entry are state capital requirements and price-regulation oversight. For an overview of the policy objectives that generally define state rate regulation, see BANKS MCDOWELL, *DEREGULATION & COMPETITION IN THE INSURANCE INDUSTRY* 34-49 (1989).

156. More than 3300 property-casualty insurance companies exist in the United States. See PETER M. LENCISIS, *INSURANCE REGULATION IN THE UNITED STATES: AN OVERVIEW FOR BUSINESS AND GOVERNMENT*, at vii (1997). The top four insurers accounted for twenty-eight percent of the market, and the top fifty insurers accounted for seventy-eight percent of the market as of 2001. See Ins. Serv. Offices, Inc., *Property/Casualty Insurance Concentration*, at <http://www.financialservicesfacts.org/financial2/insurance/pc/concentr/> (last visited Apr. 1, 2003).

subsidies created by the Act, pressures from consumers who helped to secure these rents will likely help to mitigate this danger as well.

4. *The Intractable Problem of Political Commitments and Ex Post Moral Hazard*

Another shortcoming of this plan—or any form of government subsidy for insurance—is that the same incentives that would lead politicians to enact the reinsurance program in the first place may lead them to extend ex post relief to those who were not insured or underinsured.¹⁵⁷ It is possible that politicians could point to the existence of the program to encourage more people to buy insurance up-front. This approach could limit the moral hazard by reducing expectations of compensation for the uninsured after a terrorist attack. For low-level attacks, this approach may actually work. In these instances politicians may face less popular pressure to relieve high-risk parties who had the chance to buy reinsurance yet chose to internalize the risk in the hope of compensation after the fact.

The primacy of politicians' reelection motives and the public's knowledge of this fact, however, make it difficult to imagine that the reinsurance program will eliminate this moral hazard.¹⁵⁸ The almost annual ritual of awarding subsidies to uninsured flood victims when federal insurance is readily available highlights this dilemma.¹⁵⁹ This problem appears almost unavoidable for any government insurance plan, unless politicians employed a constitutional precommitment device to limit compensation, which seems politically implausible.¹⁶⁰ Although the numbers are preliminary, only twenty-five percent of property-casualty holders offered terrorism insurance have purchased it.¹⁶¹ This fact may reflect the still significant prices for terrorism insurance or the choice to internalize this risk. The low participation rate, however, may suggest a widespread faith that the federal government will still compensate the uninsured in the event of a terrorist attack.

One way to attempt to mitigate this problem would be to make terrorism insurance mandatory for all purchasers of property-casualty insurance.¹⁶² Even this cure may have a limited effect, for individuals may

157. See Harrington, *supra* note 38, at 40.

158. See Roger G. Noll, *The Complex Politics of Catastrophe Economics*, 12 J. RISK & UNCERTAINTY 141, 142-43 (1996) (describing how benevolence has political benefits for politicians when they spend public funds to aid catastrophe victims).

159. See Harrington, *supra* note 38, at 44.

160. Epstein, *supra* note 25, at 287 (criticizing the inability of political institutions to maintain long-term commitments in the face of catastrophes).

161. See Mark A. Hoffman, *Few Buying TRIA Cover*, BUS. INS., Feb. 24, 2003, at 1.

162. This tool gives the government a theoretical advantage over other insurers in having the ability to eliminate adverse selection problems, which is the case for Social Security. See Priest, *supra* note 11, at 227.

choose to internalize other property-casualty risks and rely on the hope of government intervention in the event of a terrorist catastrophe. An even greater shortcoming of this approach is that mandating property-casualty insurance may merely accentuate the degree to which the plan engages in upward distribution toward affluent parties who have the highest risks.¹⁶³ Some universally mandatory insurance programs, such as state requirements for automobile insurance, do effect upward redistribution, although this policy is officially justified by concerns about moral hazards posed by judgment-proof drivers.¹⁶⁴ But mandatory coverage may prove to be difficult both to enforce and to make politically palatable.

The difficulty in crafting credible political commitments creates a moral hazard that is very hard to resolve. The advantage of the reinsurance plan is that it may allow for the existence of a degree of line drawing between the effects of low-level attacks that individuals and insurers must presumably address and what the federal government will address. While the point is thankfully hypothetical to date, the temptation of reelection-seeking politicians to give aid to the uninsured may prove irresistible if terrorist attacks of any kind occur once again.

C. *The Strengths of the Act and the Path for Reform*

The primary virtue of the reinsurance plan under the Act over potential government alternatives is its indirect approach. The Act continues to vest pricing decisions and risk estimations in the hands of the private market.¹⁶⁵ The use of copayments and deductibles limits the distorting effects of government intervention.¹⁶⁶ This approach partly intertwines the incentives of private insurers and the state and may provide both insurers and insured with incentive to reduce risk exposure and to limit the implicit rents. Significant political constraints may serve both to limit the potential for reform and to extend the plan's half-life. With these points in mind, this Section will suggest ways to strengthen the reinsurance plan that may create superior political and economic incentives for regulators, insurers, and the insured.

163. *But see id.* (critiquing the potential for upward redistribution through mandatory coverage requirements).

164. *See, e.g.,* Epstein, *supra* note 25, at 297 (arguing that mandatory automobile insurance is primarily designed as a redistributive mechanism for safer drivers to subsidize more risky drivers, and, implicitly, those with cheaper cars to subsidize owners with more expensive cars); *cf. MICHAEL J. GRAETZ & JERRY L. MASHAW, TRUE SECURITY: RETHINKING AMERICAN SOCIAL INSURANCE* 62-64 (1999) (discussing the downward redistribution of Social Security that forms the model of politically palatable mandatory insurance coverage).

165. *See* Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 101(b)(2), 116 Stat. 2322, 2323 (codified at 15 U.S.C.A. §§ 248, 1610, 6701 (West Supp. 2003)).

166. *See id.* § 103(e)(1), (e)(7).

1. *Learning from the Government's Poor Track Record as an Insurer*

The federal government has a long track record of poorly designed insurance policies. This fact creates understandable skepticism as to its potential efficacy as an insurer.¹⁶⁷ One strength of this reinsurance plan, however, is that its design appears to reflect lessons learned from the shortcomings of past government insurance plans.

Most government insurance programs have offered direct subsidized insurance following the model of Federal Crop Insurance and the National Flood Insurance Program.¹⁶⁸ These subsidized insurance programs are optional, which creates adverse selection problems, for only those with the most risks purchase policies. Payoffs generally occur regardless of whether the insured parties have adopted required preventive measures or purposefully courted exposure to the danger through risk-seeking decisions to build or plant. Even worse, payoffs, such as for crop damage insurance, may routinely exceed the expected benefits from the adoption of preventive measures.¹⁶⁹ Private insurers seek to segregate risks by charging different rates for different risk categories and to aggregate uncorrelated risks to reduce the insurers' own risk exposure.¹⁷⁰ In contrast, public insurance programs have historically engaged in little risk segregation, and the trigger events for compensation are often highly correlated risks.

Experts have estimated that effective rent-seeking concerning subsidized flood insurance charges has led to the government's charging as little as five percent of actuarially accurate insurance rates.¹⁷¹ Not only does massive undercharging leave the government with massive risk exposure, but also the moral hazards caused by these subsidies encourage property owners to develop land in exposed areas while shifting almost all of the risks to the federal government.¹⁷² Past alleged market failures have led to the creation of government insurance programs covering floods and mudslides,¹⁷³ weather-related damage to crops,¹⁷⁴ caps on the liability of

167. See GRON & SYKES, *supra* note 26, at 2.

168. See GEN. ACCOUNTING OFFICE, PUB. NO. GAO-02-175T, TERRORISM INSURANCE: ALTERNATIVE PROGRAMS FOR PROTECTING INSURANCE CONSUMERS 3-6 (2001), at <http://financialservices.house.gov/media/pdf/102401rh.pdf> (laying out a range of federal direct subsidized insurance programs).

169. See Priest, *supra* note 11, at 224-25.

170. See Priest, *supra* note 29, at 1540.

171. See William L. Inden, Comment, *Compensation Legislation: Private Property Rights vs. Public Benefits*, 5 DICK. J. ENVTL. L. & POL'Y 119, 144-45 (1996).

172. See *id.*

173. See, e.g., Flood Disaster Protection Act of 1973, Pub. L. No. 93-234, 87 Stat. 975 (codified as amended in scattered sections of 42 U.S.C.); National Flood Insurance Act of 1968, Pub. L. No. 90-448, 82 Stat. 572 (codified as amended in scattered sections of 42 U.S.C.).

174. See Federal Crop Insurance Act of 1938, 7 U.S.C. § 1508 (2000).

owners of nuclear power plants,¹⁷⁵ and even riot protection and inner-city burglary and robbery insurance until 1983 and 1995, respectively.¹⁷⁶

The government's direct subsidized insurance programs have historically been plagued by a litany of problems of poor government risk estimation and administration, moral hazard, adverse selection, cross-subsidies, and unbridled rent-seeking by the narrow groups of beneficiaries who have often captured the agency overseeing the terms of the insurance program.¹⁷⁷ This fact makes the reinsurance program and its indirect subsidies appear to be an innovative approach the particular design of which offers significant advantages over traditional direct government insurance programs.

One could easily imagine why proponents of the Act might have preferred the rent-seeking opportunities of direct government insurance. Nonetheless, embracing a reinsurance approach allowed proponents to distinguish the plan as a backstop rather than a direct bailout. This framing of the issue provided political cover for their rent-seeking ends and the politicians who supported them.¹⁷⁸ The claim that this reinsurance approach preempts "a much larger, more costly and poorly designed role for the government"¹⁷⁹ that could result if nothing is done and Congress responds in haste to another attack has some credence. As either a political compromise or a lesser evil, the reinsurance approach and its particular features appear to be a step forward from traditional direct subsidized programs and offer significant advantages for limiting rent-seeking.

2. *The Virtue of the Reliance on Market Pricing and an Indirect Federal Role*

The virtue of the reinsurance plan is that it shifts significant risks to the federal government, yet minimizes the government's direct role in insurance markets. Private insurers remain in charge of pricing insurance. It may be efficient for the federal government to assume catastrophic terrorism risks, which enhances the effective liquidity of insurers and their ability to withstand catastrophic attacks. There is no reason, however, to believe that the government would be more effective in gauging the terrorist risk exposure of applicants for property-casualty insurance.

175. See Atomic Energy Act of 1954, 42 U.S.C. § 2210 (2000).

176. See KENNETH J. MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 42 (1988).

177. See Levmore, *supra* note 81, at 7-9; Priest, *supra* note 11, at 225-35.

178. See *Hearing*, *supra* note 93.

179. Editorial, *Congress Should Expand Alternatives*, *BUS. INS.*, June 3, 2002, at 8 (internal quotation marks and citation omitted); *id.* (arguing that large-scale financial and commercial bankruptcies following another attack could lead to a far worse solution than the reinsurance plan).

Notwithstanding the government's terrorist intelligence capacities, private insurers appear much better situated than government bureaucrats to decide how to calculate the probability of terrorist attacks and their likely magnitude in order to determine appropriate insurance premiums. Private insurers possess both the profit incentives and the actuarial experience to conduct case-by-case analyses of risk exposure. Insurers will still face significant misestimation risks, which is part of the rationale for the Act. Nonetheless, if there is a learning curve, the reinsurance backdrop and its implicit subsidies will give insurers sufficient space to experiment and to refine their ability to estimate terrorism risks, and to segment the market into categories of relative risk exposure.

Another advantage of the government's indirect role in reinsurance is its limited nature. This approach secures the liquidity of insurers in the event of catastrophic events. The government has not fully crowded out private reinsurers, however, and has allowed reinsurers to address the substantial risks insurers still face because of deductibles and copayments. Reinsurers, such as General Electric Employers' Reinsurance Corporation, are moving to plug the gaps by offering "deductible buy-down" coverage to cover the risks posed by the deductible.¹⁸⁰ Over time as reinsurers fill the gap, it will make it (theoretically) easier to expand the role for the private sector, and perhaps to create a constituency that stands to profit from this objective.

In spite of all of the advantages of private-sector price setting, the one illusory appeal of direct government provision is the ability for a government agency immediately to ensure the availability of terrorism insurance at predictable and artificially low prices. This solution would offer short-term gain to politicians in "solving the problem" and ongoing opportunities for beneficiaries to lobby a federal agency for lower prices. The likely inability of regulators to withstand the pressures from politicians and beneficiaries would make it difficult to limit the degree of subsidies and make it much harder to minimize adverse selection problems and moral hazards. The poor track record in this regard demonstrated by a myriad of direct government insurance programs reinforces this point.¹⁸¹ In contrast, subjecting pricing decisions to market discipline by vesting these decisions in private insurers may allow subsidies to be introduced, yet limit the potential for abuses.

180. Lisa S. Howard, *Reinsurer Warns of Terror Treaty Woes*, NAT'L UNDERWRITER, Feb. 3, 2003, at 1 (laying out how reinsurers can fill a significant gap in the government's federal backstop program by offering supplemental reinsurance coverage for insurers' terrorism insurance deductibles).

181. See Levmore, *supra* note 81, at 7-9.

3. *The Use of Deductibles and Copayments To Limit Moral Hazards*

Moral hazards are virtually unavoidable in any insurance or reinsurance policy. The Act's use of deductibles and copayments for insurers, however, helps to mitigate the moral hazards that terrorism insurance creates. Substantial deductibles and ten percent copayments for damages above the deductibles provide incentives for private insurers to monitor policyholders' use of preventive measures and to implement loss-sharing devices on policyholders to limit moral hazards.¹⁸² Private insurers retain incentives to monitor policyholders and to innovate in the use of deductibles, other loss-sharing devices, or premium credits or surcharges for policyholders. These devices may provide economic incentives for companies to take precautions in building design or otherwise take steps to reduce ex ante risk exposure or mitigate post-terrorist-attack damages.

These market incentives may ultimately help to keep terrorism insurance premiums lower than they otherwise would be. Monitoring by insurers and designing premiums to give policyholders incentives to mitigate losses in the event of attacks may reduce overall risk exposure.¹⁸³ The result may be potential decreases or at least incentives for limits in implicit government subsidies through encouraging policyholders to take steps to reduce their risk exposure rather than face higher terrorism insurance premiums.¹⁸⁴

Additionally, provisions for limited mandatory recoupment of government funds and the Treasury Secretary's discretion for further recoupment theoretically introduce further incentives for insurers to reduce moral hazards.¹⁸⁵ In the event of catastrophic attacks, the President's desire for reelection or concern for his political party's fortunes would likely combine with political pressures from insurers to make it highly unlikely that the Treasury Secretary would exercise her discretionary recoupment powers. Therefore, incentives for insurers to limit moral hazards turn largely on the use of deductibles and copayments.

Obviously, if reducing risk exposure to terrorist attacks were the sole policy objective, then a simple exclusion of terrorism coverage would best

182. See Terrorism Risk Insurance Act, Pub. L. No. 107-297, § 103(e)(1), (e)(7), 116 Stat. 2322, 2328-30 (codified at 15 U.S.C.A. §§ 248, 1610, 6701 (West Supp. 2003)).

183. See Priest, *supra* note 11, at 224-25 (praising the often overlooked potential of deductibles, copayments, and exclusions to reduce moral hazards).

184. See Terrorism Risk Insurance Act § 103(e)(1), (e)(7).

185. The formula is that the Treasury Department must recoup the difference between \$10 billion in 2003, \$12.5 billion in 2004, or \$15 billion in 2005, and the aggregate of insurers' uncompensated losses for each year up to the amount of compensation given by the federal government. Thereafter, the Treasury Secretary has considerable discretion on recoupment with caps on how much of a premium she can charge each year. *Id.* § 103(e)(6), (e)(7).

effect that end.¹⁸⁶ The hope would be, however, that the use of copayments and deductibles under the Act—and, in turn, the use of deductibles by insurers—could provide protection while tempering the potential moral hazards.

In contrast, most direct government insurance provisions suffer from severe moral hazards.¹⁸⁷ This problem often occurs because of the lack of deductibles and copayments, which rent-seeking policyholders have fiercely contested and defeated. For two reasons, even a direct insurance program that did employ copayments and deductibles would likely prove less effective than a private counterpart in monitoring and designing the proper incentives. First, the government agency would not have to internalize its costs in the same way that private firms must to survive because of the agency's ability to draw on other sources of government revenues, at least in the long run. Second, a government agency providing terrorism insurance would be far more vulnerable to agency capture. In that context, politicians and special-interest beneficiaries could lean on bureaucrats more readily for rent-seeking than on their private-sector counterparts who are bound to the discipline of market pricing.

4. *The Political Constraints on Attempts To Strengthen the Act*

The existence of a formula of deductibles and copayments is a positive step forward for limiting the government's exposure to moral hazards. Nonetheless, the question remains whether politicians possess the means to set deductibles and copayments at higher levels and thereby to reduce both moral hazards and the degree of upward redistribution to insurers and high-risk beneficiaries. The higher the federal government sets deductibles and/or copayments, the greater the incentive for insurers to limit moral hazards and the more the reinsurance program will serve primarily as a liquidity device, rather than as a vehicle for indirect federal subsidies.

The advantage of the reinsurance plan is that the level of implicit rents is, in theory, "locked in" by set deductible and copayment levels for the two-to-three-year duration of the plan.¹⁸⁸ Obviously, Congress can amend the plan at any time and may do so if terrorism risk perceptions change dramatically. The need for a legislative change during the plan's initial three-year existence, however, makes changes more costly both for raising

186. *Id.*; see also Kendall, *supra* note 23, at 569-75 (highlighting the range of terrorism exclusions that have developed after the World Trade Center attacks, and suggesting their potential effects on policyholders' assumptions of risk).

187. See Priest, *supra* note 11, at 226.

188. It is advantageous for private reinsurers to be able to respond to changing circumstances and to adjust deductibles and copayments to reflect changing perceptions of risk. In contrast, the lack of market incentives for bureaucrats may make it more likely for them to abuse these powers and to become more vulnerable to capture by those they are nominally overseeing.

or reducing deductibles and copayments. This statutory “lock-in” may help to limit rent-seeking. In contrast, determined beneficiaries would have greater incentives to seek to capture federal regulators if this power were vested in a federal agency with the ability to make midstream changes in deductible and copayment levels.

For this reason, the time to push for change will be at the three-year expiration of the plan.¹⁸⁹ It is a truism in Washington that programs take on a life of their own. In this case, the existence of government reinsurance creates entrenched constituents with incentives to renew the program and to expand their rents.¹⁹⁰ Therefore, there is every reason to believe that government terrorism reinsurance is here to stay for the foreseeable future. If terrorist attacks have taken place on any scale, or if risks continue to be perceived as high, then even a modest goal of attempting to raise copayments and deductibles will prove futile in the face of reelection-seeking politicians and the array of determined rent-seekers. But if the United States continues to be blessed by the dearth of terrorist attacks on U.S. soil and international tensions in the Middle East subside (an optimistic hope to say the least), then there may be a potential political opening.

The problem is that there is no obvious political constituency that is likely to push for higher copayments and deductibles, or rather, to push back the rent-seeking ambitions of current beneficiaries. If present budget deficits continue over the next three years,¹⁹¹ then there may once again be more of a popular political constituency for fiscal responsibility. In turn, the existence of organized groups pursuing this end may provide reelection-seeking politicians with incentives to challenge the degree of implicit subsidies and moral hazards built into the Act.

The indirect nature of these subsidies, however, makes the potential cost to taxpayers harder to see. This fact makes it more unlikely that efforts to increase copayments and deductibles for insurers could be effectively framed as a political issue. Budget hawks are generally fixated on direct spending, the abuses of which may have popular political resonance, rather than on the forgone revenue implicit in tax expenditures, the very real costs of which are more difficult to fathom.¹⁹² The implicit subsidies of government reinsurance more closely resemble tax expenditures in

189. Terrorism Risk Insurance Act § 108.

190. See GRON & SYKES, *supra* note 26, at 5.

191. See Elisabeth Bumiller, *Bush's \$2.2 Trillion Budget Proposes Record Deficits*, N.Y. TIMES, Feb. 4, 2003, at A1 (noting that the Bush Administration is estimating budget deficits of \$304 billion for 2003 and \$307 billion for 2004).

192. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES & POLICIES 39-45 (rev. 4th ed. 2002) (discussing the fact that tax expenditures and direct spending are perceived as different, yet have the same net effects).

imposing possible costs in the distant future. Reelection-seeking politicians will naturally focus more on short-term concerns.

The limiting features of the Act, however, provide a foundation on which proponents of imposing copayments and/or deductibles can hope to build. The Act already incorporates a gradually increasing deductible requirement that requires individual insurers to cover losses for terrorism attacks equal to 1% of direct earned premiums in 2002, 7% in 2003, 10% in 2004, and 15% of direct earned premiums in 2005.¹⁹³ The Act also explicitly states that the reinsurance program is designed to serve as “a transitional period for the private markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses.”¹⁹⁴ These facts may allow proponents of higher copayments and/or deductibles to frame their objective of continuing to incrementally increase deductibles as consistent with the purpose of the Act. Beneficiaries may be able to claim that the threat is ongoing and frame the existing reinsurance levels as inadequate. But appeals to the underlying goals of the Act may place rent-seeking beneficiaries on the defensive by couching the debate in terms of limiting implicit subsidies and transitioning toward a larger role for the private sector.

IV. CONCLUSION

The current Act reflects the political reality of concentrated interests of insurers and businesses. This group had the influence and the platform to push for the government’s assumption of much of their terrorist risk exposure. The Act disproportionately assists the insurers and affluent property owners who face the highest risks from terrorism, yet it contains significant safeguards that limit the potential for rent-seeking and distorting effects on participants’ behavior. The Act’s reliance on market pricing limits rent-seeking by subjecting prices to market discipline. The use of copayments reduces moral hazards. The employment of deductibles limits the burden shifting to the government primarily to catastrophic terrorism risks. These advantages do not eliminate the upward redistribution, which would be inevitable in almost any government solution to address terrorism risks that by nature disproportionately affect the affluent. Nonetheless, the Act serves as a politically and economically viable solution that partly addresses the substantive economic challenges facing terrorism insurance, yet limits the potential for abuse and further extension of rents for the three-year term of the plan.

193. These deductibles are termed “marketplace retention.” Terrorism Risk Insurance Act § 103(e)(6).

194. *See id.* § 101(b)(2).

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The threat of terrorism is one that is likely to be with us so long as the United States maintains its global role. If terrorist threats continue to remain perceived as real and substantial, entities facing high terrorism risks will have both the incentives and likely the political means to continue to secure government rents by reducing their risk exposure. Changes two to three years hence at the expiration of the Act's program will obviously be contingent on the degree of perceived threats. Policymakers should work within political constraints on continuing to increase deductibles and copayments. This approach would reduce implicit subsidies and move the reinsurance plan toward primarily serving as a liquidity device for catastrophic terrorist attacks. Even in its present form, however, the Act is a significant step forward in the design of government insurance programs. It serves as a model of how, even in the context of overwhelming rent-seeking pressures, policymakers can incorporate market safeguards that limit the distorting effects of government intervention.