



**NEW RISKS, NEW PRODUCTS, AND NEW REGULATIONS:  
INSURANCE FOR THE 21ST CENTURY**

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By

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**Abstract**

This paper considers some of the key issues and problems facing the insurance industry at the start of the 21<sup>st</sup> century, including terrorism risk, natural disasters, insurance accounting issues, and problems with the current regulatory structure. It outlines important steps that insurers and regulators can take to address and alleviate these problems and makes recommendations for the reform of the current regulatory structure.

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## I. NEW RISKS AND NEW REGULATIONS

The Barbon Institute is named after Nicholas Barbon, a Seventeenth Century Englishman who is considered to be a founder of the modern insurance industry.<sup>1</sup> Barbon was an educated and wealthy man, an economist, physician, builder and, ultimately, an insurer.<sup>2</sup> He was inspired to become an insurer by the Great Fire of London in 1666. The Great Fire destroyed four-fifths of the city of London—then largely a city of wooden buildings and thatched roofs.<sup>3</sup> This terrible conflagration struck the city hard on the heels of the previous year's Great Plague, which killed 15% of the city's inhabitants.<sup>4</sup>

In the aftermath of the fire, Barbon created two important innovations. The first was the creation of organized fire departments, to limit the damage from future fires and prevent a repeat of the "Great" fire.<sup>5</sup> The second was the creation of fire insurance, which would blunt the impact of those fires that did occur. Individuals and businesses would be compensated for their losses, and this, in turn, would allow them to recover and rebuild.

It is not clear precisely how Barbon arrived at the idea of selling insurance policies to protect properties and structures against fire. Whatever the reason, it was a great idea. With insurance to protect themselves against future devastation (along with the fire departments to help prevent it), some of London's merchants and residents were able to return to the city and rebuild with greater confidence about the future.

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<sup>1</sup> Klein, G. Barry, "The World's First Insurance Company," International Risk Management Institute, July 2001. Available at <http://www.irmi.com/Expert/Articles/2001/Klein07.aspx>.

<sup>2</sup> See Klein, *supra* note 1.

<sup>3</sup> Jokinen, Anniina, "The Great Fire of London, 1666," *Luminarium*, Oct. 26, 2001. Available at <http://www.luminarium.org/encyclopedia/greatfire.htm>.

<sup>4</sup> "How Did London Respond to the Great Plague of 1665-6," The National Archives of England, Wales and the United Kingdom. Available at <http://www.learningcurve.gov.uk/snapshots/snapshot49/snapshot49.htm>.

<sup>5</sup> Klein, *supra* note 1. Barbon created insurer-owned private fire departments, each of which, unfortunately, would only put out fires of buildings insured by a particular company. As Klein notes, this could lead to a fire department responding to a raging fire and departing without taking action if the building was not insured by that department's parent company.

If insurance was a boon to the few in the 17<sup>th</sup> century who owned property, it is nearly indispensable to all 21<sup>st</sup> century consumers and business owners in developed economies. For the modern consumer, insurance helps to provide some measure of certainty in an uncertain and perilous world. Modern consumers face risks to life and property, financial risks, liability risks, and many others. Individuals and businesses want and need to protect their property and investments against these risks. Insurance can help manage many of those risks, giving individuals and businesses the confidence to invest, create, and build, knowing that the wealth they generate will be protected.

As our society has become more prosperous, and wealth has increased, we have more to lose than ever and the risks facing consumers and businesses seem as significant as they have ever been. Some of these risks are new, and some are long-standing. The risk posed by natural disasters, for example, though certainly not new, has become even more severe in the last decade as hurricanes and other weather-related catastrophes have become more frequent, and coastal development has placed more people and property in the line of fire from these destructive events.<sup>6</sup> There are also new and daunting risks such as that presented by global terrorism, particularly terrorist acts employing weapons of mass destruction.

Globalization has made the world smaller as well as flatter. American consumers now purchase electronics from China, software from Europe, medical services from India, and food from South America. The insurance industry, no less than any other major industry, has a global reach, and a global presence. Today, many large insurance companies, reinsurance companies and insurance brokers operate throughout the world. This network of providers brings new, innovative, and reliable insurance products to businesses and consumers everywhere. Consumers

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<sup>6</sup> See, e.g., Kunreuther, Howard, "Reflections on U.S. Disaster Insurance Policy for the 21<sup>st</sup> Century," Jul. 2006, p. 2.

benefit from a wide selection of providers, and increased competition for their business. The insurance industry, in turn, has the opportunity to diversify and spread its risks across a wider base than ever before.

Globalization of this kind has been an engine of economic prosperity around the world. It has fostered greater competition, and provided superior goods and services at affordable prices to consumers worldwide. In addition, it helps to restrain global inflation<sup>7</sup> and keeps interest rates in check.<sup>8</sup> But as the world has become more interconnected, distance no longer provides protection from the consequences of adverse events, and remote threats no longer remain remote. Consider just one recent example; air travel in the United States, Europe and around the world was seriously disrupted in August 2006 when British authorities discovered a terrorist plot to set off bombs in airplanes bound for America over the Atlantic Ocean.<sup>9</sup> The actions of a few individuals disrupted commerce and travel for thousands, perhaps millions, of people.

Natural disasters can have a similar effect on markets and people throughout the world. When Hurricane Katrina struck the Gulf Coast of the United States, its effects were felt throughout the U.S. and even across oceans. The storm knocked out natural gas and oil pipelines in Houston and shut down the fuel distribution system throughout much of the southern United States. This drove up gas prices across the U.S. The possibility of serious disruptions in the U.S. oil supply also roiled international markets. In the United Kingdom, for example, British consumers were buffeted by a surge in gasoline prices triggered by the hurricane and its

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<sup>7</sup> Federal Reserve Bank of Dallas, "Reducing Inflation's Bite," in *Racing to the Top: How Global Competition Disciplines Public Policy*, 2005 Annual Report, p. 11. Available at <http://dallasfed.org/fed/annual/2005/ar05.pdf>.

<sup>8</sup> Kohn, Donald L., "Globalization, Inflation, and Monetary Policy," Remarks by Governor Donald L. Kohn At the James R. Wilson Lecture Series, The College of Wooster, Wooster, Ohio, Oct. 11, 2005. Available at <http://www.federalreserve.gov/boardDocs/Speeches/2005/20051011/default.htm>.

<sup>9</sup> Cowell, Allen, & Filkins, Dexter, "U.K. foils plot to bomb U.S.-bound planes," *International Herald Tribune*, Aug. 10, 2006. Available at <http://www.iht.com/articles/2006/08/10/news/terror.php>.

aftermath.<sup>10</sup> As for the U.S. insurance industry, it was faced with over \$40 billion in claims following Katrina, stretching the resources of many insurers.<sup>11</sup> The stock market value of the insurance industry as a whole also took a significant hit, with the average stock price of the top insurers and reinsurers plunging 6 percent in the weeks after Katrina.

The world is obviously facing threats that must be managed. To respond, the insurance industry must step up to meet the new challenges of the 21st century. The industry must innovate just as Nicholas Barbon did, and government policy must encourage and support that innovation. Faced with the threat of terrorism and escalating natural disasters, some in the industry and in the policy community have called for increased government intervention in insurance. But while government surely has an important role to play in this industry, its proper role is limited. Government can perhaps assist most by removing regulatory barriers that have hampered the efficient operation of the insurance marketplace and stifled innovation.

The insurance industry can and should assume a greater role in providing products and services that protect consumers in the face of uncertainty and loss. The free operation of the market will always provide more efficient pricing and allocation of capital than will even the best-intentioned government regulators. Furthermore, the industry has the knowledge, experience, and incentives to accurately and rationally evaluate risk and respond accordingly.

## II. SIGNIFICANT ISSUES

In the following pages, this paper will address four significant issues facing the United States insurance industry, and offer some guidelines for reforms that will help to address them.

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<sup>10</sup> "Economic effects of Hurricane Katrina," Wikipedia. Available at [http://en.wikipedia.org/wiki/Economic\\_effects\\_of\\_Hurricane\\_Katrina](http://en.wikipedia.org/wiki/Economic_effects_of_Hurricane_Katrina) (viewed Oct. 4, 2006).

<sup>11</sup> "Hurricane Katrina Fact File," Insurance Information Institute, p. 1. Available at [http://server.iii.org/yy\\_obj\\_data/binary/759496\\_1\\_0/Hurricane%20Katrina%20Fact%20File.pdf](http://server.iii.org/yy_obj_data/binary/759496_1_0/Hurricane%20Katrina%20Fact%20File.pdf).

The issues are: (1) insurance and terrorism risk; (2) natural disasters; (3) accounting rules constraining industry practices; and (4) current regulatory policies.

### **A. Terrorism**

Until recently, the United States had the luxury of ignoring terrorism, and insurance policies reflected that. Insurance policies generally did not even recognize terrorism as a distinct threat. To the extent underwriters considered the issue, they did not consider it important enough to mention, let alone exclude, in standard property policies. The events of September 11, 2001 brought home the harsh realization that terrorism is now an unfortunate fact of life. If there were any doubt concerning its continuing threat, the August 2006 plot to destroy airliners over the Atlantic – literally weeks before the fifth anniversary of 9/11 - should lay that doubt to rest.<sup>12</sup>

Of course, there have been military and other international threats before, including the Cold War threat of nuclear war. However, the current terrorist threat differs from these in its amorphous and unpredictable. In past conflicts we could see and assess the threat, but today that is not so. Even when we were staring down the Soviets during the Cold War, the threat was known, and the consequences, though potentially enormous, were at least also known. In the case of terrorism, we do not even necessarily know from where threats will arise. Terrorists are not just far away in the Middle East; they are among us. Moreover, we do not always know what motivates terrorists. Neither the Soviets nor the United States wanted nuclear war, and we could negotiate with that common understanding. We have no such common understanding with Al Qaeda or others like them.

Finally, unlike natural disasters, terrorism adapts. Terrorists respond to new information and adapt to our efforts to mitigate the potential damage they might unleash. The more security we apply to one potential target, the less likely it is that terrorists will strike that target. Security

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<sup>12</sup> See Cowell and Filkins, *supra* note 9.

is and will likely continue to be, a kind of arms race; we create new security, terrorists change their tactics, and we, in turn pursue new avenues to secure against future attack. Experts believe that there is no way that we can achieve perfect security from terrorism;<sup>13</sup> the only question is whether we can reduce its likelihood, mitigate its impact, or manage its consequences.

The risk of terrorism, therefore, has many implications for the insurance industry. Many commercial banks now require terrorism insurance for property owners. Roughly 25% of all commercial loans, and nearly all of the larger commercial mortgages, have such requirements, and industry surveys show that investors require terrorism insurance on 94% of all outstanding commercial/multifamily loans.<sup>14</sup> In fact 60% of large and mid-sized businesses now have terrorism insurance.<sup>15</sup> The demand for terrorism insurance is there. But how secure is the supply? To ensure that supply, several problems must be addressed – and in a way that neither threatens insurers’ solvency nor compromises the interests of the people and businesses that rely on the industry for coverage.

The first problem is a lack of information. Insurers rely on accurate risk information to determine appropriate pricing, reserving, and investment strategies. Without such information, creating a functional insurance market is nearly impossible. Terrorists, on the other hand, rely on stealth and secrecy to maximize the disruption and destruction they cause. Thus, unlike natural disasters, terrorist attacks do not follow predictable patterns. They are man-made events, subject

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<sup>13</sup> “The 9/11 Commission Report,” *The 9/11 Commission*, Jul. 2004, p. 383. Available at <http://www.9-11commission.gov/report/911Report.pdf>.

<sup>14</sup> “Federal Terrorism Reinsurance: An Update,” Congressional Budget Office, Washington, DC, Jan. 2005. Available at <http://www.cbo.gov/showdoc.cfm?index=6049&sequence=2>. See also “TRIA and Beyond: Terrorism Risk Financing in the U.S.,” Wharton Risk Management and Decision Processes Center, The Wharton School, University of Pennsylvania, Aug. 2005, p. 151, n. 199. Available at <http://opim.wharton.upenn.edu/risk/downloads/TRIA%20and%20Beyond.pdf#search=%22commercial%2Fmultifamily%20loans%20%26%20%22terrorism%20insurance%22%20%26%20survey%20%26%2095%22>. The Wharton study notes, “A survey published in 2004 by the Mortgage Bankers Association (MBA) of 123,000 commercial/multifamily loans (totaling \$656 billion) showed that terrorism insurance was required by the mortgage investor and/or servicer on \$616 billion of these loans.”

<sup>15</sup> “6 in 10 Business Now Buying Terror Coverage, Marsh Reports,” *Insurance Journal*, Aug. 25, 2006. Available at: <http://www.insurancejournal.com/news/national/2006/08/25/71713.htm>.

only to the ingenuity and technology of the terrorists themselves. No two attacks need be the same, in their execution, methodology, or choice of target.

Other than the terrorists themselves, the federal government is the party most likely to have the best knowledge of potential terrorist threats. The U.S. government commits massive resources and invests enormous sums of money to gather intelligence about terrorists. But, for predictable and logical security reasons, they generally cannot share what they know about terrorists and their activities without jeopardizing the effectiveness of anti-terrorism efforts.

In addition, terrorism risk is unique in the potential magnitude of losses involved. The insurance industry sustained losses of approximately \$35.5 billion as a result of the 9/11 terrorist attacks.<sup>16</sup> That was comparable to industry losses from Hurricane Katrina.<sup>17</sup> The industry can and should cover events of this size. However, the 9/11 attacks, as destructive as they were, do not approach the limit of potential damage from terrorism. What if the terrorists had had even a relatively small nuclear weapon? They could have destroyed not only the World Trade Center, but all of lower Manhattan. Or what if a radiological or so-called “dirty bomb” were detonated in downtown Chicago? The losses would be on an unprecedented scale, and might very well overwhelm the capacity of the insurance industry. A subgroup of the American Academy of Actuaries has estimated that a large-scale attack with a weapon of mass destruction in New York City could result in insured losses of over \$700 billion.<sup>18</sup>

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<sup>16</sup> Valverde, Dr. James L., Jr., & Hartwig, Dr. Robert P., CPCU, “9/11 and Insurance: The Five Year Anniversary.” Insurance Information Institute, Sep. 2006, at 2. Available at: [http://server.iii.org/yy\\_obj\\_data/binary/760752\\_1\\_0/September%2011%20Anniversary.pdf#search=%22%22insured%20losses%22%20%26%209%2F11%22](http://server.iii.org/yy_obj_data/binary/760752_1_0/September%2011%20Anniversary.pdf#search=%22%22insured%20losses%22%20%26%209%2F11%22). Figure is in 2006 dollars.

<sup>17</sup> As noted above, insurers sustained losses of just over US\$40 billion. See “Hurricane Katrina Fact File,” Insurance Information Institute, at 1. Available at [http://server.iii.org/yy\\_obj\\_data/binary/759496\\_1\\_0/Hurricane%20Katrina%20Fact%20File.pdf](http://server.iii.org/yy_obj_data/binary/759496_1_0/Hurricane%20Katrina%20Fact%20File.pdf)

<sup>18</sup> McCarter, Michael G., FCAS, MAAA, “Statement of Michael G. McCarter, FCAS, MAAA, Chairperson, Terrorism Risk Insurance Subgroup, American Academy of Actuaries, before the Terrorism Insurance Implementation (C) Working Group, National Association of Insurance Commissioners, Public Hearing on

Facing numbers like this, some in the industry have concluded that terrorism, at least involving weapons of mass destruction, is a risk that is simply uninsurable. Shortly after 9/11, Congress passed the Terrorism Risk Insurance Act (“TRIA”), which was intended to serve as a temporary backstop to the industry to allow private insurers to develop new tools or greater capacity to deal with these terrorism risks. When TRIA was set to expire at the end of 2005, Congress passed a temporary extension of the Act, the Terrorism Risk Insurance Extension Act (“TRIEA”). TRIEA is set to expire at the end of 2007.

These stop-gap measures do not address the fundamental underlying problem in addressing terrorism risk. More work must be done, for example, to develop new ways to forecast, model, and assess terrorism risk and potential losses. Developing these new tools and methodologies will require government-industry cooperation, perhaps through an industry-government working group on terrorism risk. Such a group could evaluate the industry’s capacity and help to develop new risk-assessment tools. Without such tools, the industry may not be able to properly price terrorism insurance, thus endangering insurers’ solvency and putting policyholders at risk. Only when these risks and the industry’s capabilities have been effectively assessed can policymakers determine the proper role of government in this market.

The industry can contribute to these efforts by developing new financial tools for handling large-scale risks. Insurers and others have already developed new devices such as catastrophe bonds, options, and other securities to help hedge and spread the risks of natural disasters. Tools of this sort are likely to be useful in the terrorism insurance market as well. With better tools for assessing terrorism risks and new risk management strategies to spread and

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“Terrorism Insurance Matters,” American Academy of Actuaries, Mar. 29, 2006, at 4. Available at [http://www.actuary.org/pdf/casualty/tris\\_032906.pdf](http://www.actuary.org/pdf/casualty/tris_032906.pdf).

manage them, the insurance industry could likely assume a greater role in insuring against terrorist attacks.

The federal and state governments can help promote industry innovation by removing regulatory impediments that hamper the industry's ability to underwrite and manage risk. These include accounting requirements, rate regulation, underwriting restrictions, and other types of regulations that I will address in greater detail later.

Governments should not offer insurance directly. Government insurance would crowd out private insurance and create disincentives for private insurers to develop new risk management strategies or capital resources. Nevertheless the federal government can play an important role by providing a backstop for policyholders in insuring against attacks involving weapons of mass destruction. Any terrorist attack using weapons of mass destruction, i.e. nuclear, biological, chemical, or radiological ("NBCR") weapons, would be enormously destructive, and would likely cause damage well in excess of the industry's financial capacity.

Two recent government studies highlight the difficulties of insuring against damage caused by weapons of mass destruction. A recent GAO study noted, "Insuring NBCR risks is distinctly different from insuring other risks because of the potential for catastrophic losses, a lack of understanding or knowledge about the long-term consequences, and a lack of historical experience with NBCR attacks in the United States."<sup>19</sup> The report of the President's Working Group on Financial Markets made similar findings regarding such risks, noting that insurers have

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<sup>19</sup> "Terrorism Insurance: Measuring and Predicting Losses from Unconventional Weapons Is Difficult, but Some Industry Exposure Exists," United States Government Accountability Office, Sep. 2006, p. 3. Available at <http://www.gao.gov/cgi-bin/getrpt?GAO-06-1081>.

not offered such coverage in the past, and generally do not offer such coverage today, even with the federal backstop, offered by TRIEA, in place.<sup>20</sup>

The backstop provided by TRIA and TRIEA gave the industry some breathing room to come to terms with the new reality of terrorism risk. And the program created and maintained by these Acts represents a good example of appropriate government involvement in a troubled market. It created a public-private partnership that made use of the strengths of both the insurance industry and the U.S. government. This program, or one like it, should be made permanent, with the respective roles of government and industry spelled out carefully.

While, as noted above, a large and destructive terrorist attack using weapons of mass destruction could result in losses in excess of \$700 billion, the property/casualty insurance industry, as a whole, has only about \$150 billion in capital to back all insured risks reinforced by TRIEA.<sup>21</sup> If losses are too high, the industry simply will not have the capital to reimburse its policyholders. Whether or not the government commits to support this market before such an event, the citizens of this country, who will seek to rebuild in the aftermath of such an attack, will seek out the federal government's assistance to cover their losses.

Following a significant terrorist attack, the federal government would, without question, provide massive amounts of aid, even in the absence of a terrorism insurance program, to assist in rebuilding property and stabilizing the economy and financial markets. The American people

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<sup>20</sup> See "Terrorism Risk Insurance: Report of the President's Working Group on Financial Markets," President's Working Group on Financial Markets, Sep. 2006, p. 5. Available at <http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/report.pdf>. ("Historically, insurance coverage for losses associated with chemical, nuclear, biological, and radiological risks has generally not been widely available unless it was mandated. Insurers generally did not provide CNBR coverage even before September 11, and for the most part they do not provide such terrorism coverage even with a Federal backstop in place. Given the general reluctance of insurance companies to provide coverage for these types of risks, there may be little potential for future market development").

<sup>21</sup> Kelly, Edmund F., "Testimony of Edmund F. Kelly, Chairman, President and Chief Executive Officer, Liberty Mutual Group" before the U.S. House of Representatives Committee on Financial Services, Joint Hearing of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, and the Subcommittee on Oversight and Catastrophic Terrorism Risk, Sep. 27, 2006, p. 7.

would be better served if a program were already in place that clearly defined the post-attack roles of the federal government and private industry. This would help to allay the very real hardship that would be caused by delay, indecision, or lack of organization inherent in an *ad hoc* government aid or emergency response program. We saw the consequences of that approach in the aftermath of Hurricane Katrina.<sup>22</sup>

Thus to maximize the joint effectiveness of industry and government, the federal government's role in the terrorism insurance market must be strictly delineated. As noted, it would be a mistake to have the federal government offer terrorism insurance directly. The insurance industry has greater expertise and better incentives to price insurance appropriately. A government insurance program would be under constant pressure to make coverage affordable, even at the expense of actuarial soundness, and to put in place cross-subsidies of various sorts, leading to mispricing. The industry, because it has the incentive to make a profit on this product, as with all insurance products, has the incentive to find the prices that appropriately cover the risks faced by individual policyholders. Furthermore, a relatively high premium can give policyholders important incentives to reduce their exposure, to the extent that they can do so. If they can present less risk to the insurer, they should reduce their premiums.

The federal government should limit its role to serving as a backstop for only the most extreme losses resulting from the use of weapons of mass destruction. Permanent reform must be structured so that federal government support adds to the capacity of the insurance industry but does not crowd out private innovations, such as efforts at securitization or expansion of reinsurance capacity. Some commentators have asserted that *any* federal government involvement would distort the market for terrorism insurance, effectively subsidizing insurance

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<sup>22</sup> See, e.g., "A Failure of Initiative: Final Report of the Select Bipartisan Committee to Investigate the Preparation for and Response to Hurricane Katrina," U.S. House of Representatives, U.S. Government Printing Office, Feb. 15, 2006. Available at <http://www.gpoaccess.gov/katrinareport/fullreport.pdf>.

purchasers and crowding out securitization with cheaper government funds.<sup>23</sup> To avoid this, government involvement in the insurance markets must be structured carefully so that it can provide support for policyholders in the event of the very largest terrorist megacatastrophes but avoid creating disincentives for private market innovation.

A program of this kind would provide assurances to policyholders that their policies will be honored. This would be akin to the protection offered by the Federal Deposit Insurance Corporation (“FDIC”) that assures bank depositors that their accounts are protected. A permanent federal terrorism insurance program, if designed correctly, could provide similar assurances to insurance consumers. As with FDIC protection, this protection will, we all hope, rarely be needed. Nevertheless, such a program would provide confidence to both policyholders and insurers.

## **B. Natural Disasters**

Natural disasters pose their own set of challenges to the insurance industry. The United States seems to be experiencing an increasing number of natural disasters, particularly hurricanes. Some scientists blame the increasing incidence of Atlantic hurricanes on global warming,<sup>24</sup> while others point to alternative natural phenomena, such as the Atlantic multi-decadal oscillation.<sup>25</sup> Whatever the cause, the available data show that the frequency and severity

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<sup>23</sup> See Rhee, Robert J., “Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance and Government Action,” *Arizona St. Law Journal*, Vol. 27 (2005).

<sup>24</sup> See, e.g. Mann, M.E., & Emanuel, K.A., “Atlantic Hurricane Trends Linked to Climate Change,” *Eos*, Vol. 87, No. 24, Jun. 13, 2006, p. 233. Available at <http://www.meteo.psu.edu/~mann/shared/articles/MannEmanuelEos06.pdf>.

<sup>25</sup> See, e.g. Klotzbach, Phillip J., & Gray, William M., “Extended Range Forecast of Atlantic Seasonal Hurricane Activity and U.S. Landfall Strike Probability for 2006.” Department of Atmospheric Science, Colorado State University, Apr. 4, 2006. Available at <http://typhoon.atmos.colostate.edu/forecasts/2006/april2006/>. See also Klotzbach, Phillip J., “Trends in Global Tropical Cyclone Activity over the Past Twenty Years (1986-2005),” *Geophysical Research Letters*, Vol. 33, L10805, May 20, 2006. Available at <http://typhoon.atmos.colostate.edu/Includes/Documents/Publications/klotzbach2006.pdf>.

of hurricanes and floods have increased markedly in recent years.<sup>26</sup> Needless to say, this is problematic for the insurance industry.

Even so, the insurance industry has provided coverage for hurricanes and storm damage for decades and should be able to continue handling these risks—provided that courts and policymakers respect contractual policy limitations and exclusions, and so long as public policies permit insurers to underwrite and price risk freely. The recent decision by a U.S. District Court in Mississippi in *Leonard v. Nationwide Insurance Co.* was important in this regard. This decision upheld the exclusion in Nationwide’s policy for coverage for damages resulting from floodwater. The decision reinforced the notion that the industry should pay for losses on the same basis as they have collected premiums.<sup>27</sup>

The industry will still need to make adjustments to deal with increasingly severe storms causing larger and more frequent losses. Business as usual will not suffice. As with terrorism insurance, insurers will need to innovate to develop new ways to spread risks. Insurers have, in recent years, begun using catastrophe bonds, options, derivatives, and other financial instruments to spread some of the risk of catastrophic events to the capital markets. New developments of this kind will be critical for expanding the capacity of the insurance industry to insure against losses from natural disasters.

### **C. Accounting Regulations**

Antediluvian accounting regulations currently stifle the ability of insurers to expand the supply of available coverage. To address the risks of terrorism and natural disasters, it is critical that policymakers remove outdated accounting regulations so that insurers can increase capacity and offer greater coverage.

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<sup>26</sup> See Kunreuther, *supra* note 6, at 2.

<sup>27</sup> See *Leonard v. Nationwide Ins. Co.*, No. 1:05CV475 LTS-RHW (S.D. Miss. Aug. 15, 2006). Slip opinion available at <http://www.mssd.uscourts.gov/news/Leonard%20v.%20Nationwide%20final%20opinion.pdf>.

Consider first the effect of current laws and regulations regarding the taxation of insurance company income. Under the present system, insurers are saddled with three layers of taxes. All corporate shareholders face “double taxation”: the corporate income tax is followed by personal taxation of dividends and capital gains. Insurance company shareholders face a third layer of taxes: an insurance company must pay taxes on income from capital even though it has already been taxed as corporate income.

The effect of this tax structure is to make it cheaper for insurance companies to rely on reinsurers to diversify risk than to accumulate capital reserves or transfer risk to the financial markets. Current laws encourage the purchase of reinsurance, and discourage reserving, self-insurance and investment. Though the mere mention of tax and accounting rules may cause some policymakers’ eyes to glaze over, these rules turn out to be extremely important for insurance reform. These rules have very real effects on the actions of insurers, and consequently, very real effects on consumers. Current rules discourage insurers from pursuing promising new avenues for risk diversification, and insurers and consumers are both made worse off.

Current accounting rules discourage insurers from pursuing new ways to shift risks into the capital markets, even though the capital markets can absorb far more risk than insurers or reinsurers. The stock market crash of 1987 caused investor losses of \$500 billion in one day in the U.S.<sup>28</sup> By contrast, Hurricane Katrina resulted in insured losses of around \$40 billion, and the events of 9/11 resulted in insured losses of approximately \$36 billion. While 9/11 strained the capacities of some insurers, the capital markets were able to absorb the losses from the stock market crash with relative ease. The size of derivatives markets alone exceeds \$100 *trillion*.<sup>29</sup>

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<sup>28</sup> “Black Monday – The Stock Market Crash of 1987,” Stock Market Crash. Available at <http://www.stock-market-crash.net/1987.htm>.

<sup>29</sup> See “Primer: Derivatives,” Financial Policy Forum, 2002. Available at <http://www.financialpolicy.org/dscprimer.htm>. See also Pulpava, James J., “Storm Watch: Rogue Waves and

Worldwide financial markets have the experience and resources to absorb large-scale losses without significant disruption. Making it easier for insurers to spread and diversify risks into financial markets would clearly expand the industry's ability to handle catastrophic losses.

Despite current accounting and tax rules, insurers have created a number of innovative financial products. They have successfully used catastrophe bonds to securitize insurance risk and transfer those risks from the bond sponsor (usually an insurer) to investors. Catastrophe options, swaps, and derivatives have also been developed and put to use. Catastrophe options have been trading on the Chicago Board of Trade since 1992. These are positive developments, and changing accounting rules should encourage more such innovation. Considering the growing risks of natural and man-made catastrophes, insurers should be encouraged to use all the tools available to them to diversify risk. Insurers need to be able to shift risk more easily to the capital markets if they are to expand their capacity and the market's ability to insure against natural disasters and terrorism.

Current accounting rules not only discourage spreading risk to capital markets, they also discourage insurers from accumulating capital reserves. Present rules allow insurers to create reserves for incurred but not reported ("IBNR") losses only so long as these losses are tied to specific covered incidents. This is not the optimal approach to structuring reserves. Insurance, particularly with regard to catastrophic losses, is cyclical. Years in which insurers face considerable losses from natural disasters could be followed by quiet years with fewer losses. In Europe, insurers are able to smooth the cycle of gains and losses by accumulating *general* reserves during low-loss periods – reserves that are not tied to specific events – to help reduce the financial effect of high-loss years in the future.

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Standard Deviations - Part 2," *The Gilded Opinion*, May 17, 2002. Available at <http://www.usagold.com/gildedopinion/puplava/20020517.html>.

If accounting rules were changed to allow U.S. insurers to accumulate reserves of this kind, it would have several effects. It would allow insurance companies to accumulate reserves during profitable years to apply those funds to cover catastrophic losses. It would also have an effect on insurers' financials. It would reduce earnings on the insurers' books in low-loss years. It would thus be important to make the reserving process transparent to investors and regulators by having these reserves referenced in the notes of a company's financial statements. Altering accounting rules to make this change would strengthen insurer solvency, increase the ability of the industry to absorb losses from catastrophic events, and expand the supply and availability of insurance to consumers.

These reserves would also allow insurers to better diversify risk over time, something that is nearly impossible under current rules. Current rules require that insurers register the full value of an insured loss immediately. If a hurricane in Florida results in \$500 million in insured losses for a particular insurer, current rules require the insurer to immediately record that loss on its books as a \$500 million liability. But this does not match the real world process of paying claims. Though the insurer must account for the entire liability immediately, that \$500 million will not be paid out immediately, but rather, at a future time when all the claims have been filed and approved. It would make much more sense to reform accounting standards to reflect this reality. This would free up capital and expand capacity.

#### **D. Regulation of Insurance**

The current insurance regulatory structure is inefficient and heavy-handed. While other industries such as airlines, telecommunications, banking, and trucking have experienced waves of deregulation, an insurance industry in which many firms operate nationally is locked into a

creaky and antiquated system overseen by individual states. These states exercise considerable oversight, even over the premium rates that insurers may charge for some products.<sup>30</sup>

This regulatory model dates back to a 1868 Supreme Court decision which held that the regulation of insurance contracts was properly the province of the states and that insurance transactions were local transactions “governed by the local law,” thus not subject to Congress’s power to regulate interstate commerce.<sup>31</sup> During World War II, the Court altered its interpretation and acknowledged that insurance transactions could be regulated by the federal government.<sup>32</sup> Nevertheless, while the Supreme Court held that Congress had the power to regulate insurance markets, Congress declined to do so. Instead, it passed the McCarran-Ferguson Act, which specifically reserved the regulation of the business of insurance for the states. McCarran-Ferguson remains in effect to this day.

The practical effect of the current regulatory structure is that a U.S. insurer that seeks to do business nationwide must comply with the insurance codes of 50 states and the District of Columbia and deal with 51 regulatory agencies. This creates a stunningly complex, inconsistent, even contradictory regulatory morass that insurers must somehow navigate, and it requires that insurers dedicate enormous efforts and resources to regulatory compliance. Multi-state regulation is expensive, inefficient, discourages innovation, limits competition, increases compliance costs, and raises the costs of entry into many markets. This results in fewer choices for consumers, and higher costs for the insurance products that are available.

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<sup>30</sup> For a good discussion of insurance rate regulation, the problems and distortions these regulations can cause in insurance markets, and efforts at deregulation and reform, see Harrington, Scott E., “Insurance Rate Deregulation,” Paper Presented at AEI’s “Rate Deregulation and Consumers,” Sep. 21, 2006. Available at [http://www.aei.org/docLib/20060919\\_HarringtonPaper.pdf](http://www.aei.org/docLib/20060919_HarringtonPaper.pdf).

<sup>31</sup> Paul v. State of Virginia, 75 U.S. (8 Wall.) 168, 183 (1868).

<sup>32</sup> See United States v. South-Eastern Underwriters Ass’n, 322 U.S. 533, 551-553 (1944) (The court held, among other rulings, that business enterprises which conducted business across state lines were not exempt from Congress’s regulatory power, and insurance was no exception to this general rule).

The insurance industry is plainly no longer a business of small local companies serving local consumers and businesses. Insurance transactions involve national and international companies selling products throughout the world. This is not the world in which state regulation was born. In this global marketplace, it would seem to make sense to shift some industry regulation to the federal level. New legislative proposals offer an interesting approach for how this might be done. S. 2509, the National Insurance Act of 2006, and a companion bill in the House, H.R. 6225, would give insurance companies the option to choose either federal or state charters and, consequently, federal or state regulation. Much as banks are allowed to do under present law (and for similar reasons), insurers would be able to choose whether they wish to be regulated by the federal government or by the states. The choice would be an either-or proposition, and these legislative proposals intend to avoid the possibility of dual regulation by *both* the federal and state governments. This would avoid problems of duplicative and redundant regulation by both the federal and state governments, and could, perhaps, engender a kind of regulatory competition between the federal government and the states that could encourage efficiency and intelligent reform.

Allowing insurers the option of choosing federal regulation would place U.S. insurers on a similar footing with their international competitors. It might also encourage foreign insurers to enter the U.S. market, knowing that they would face a single regulator, rather than having to wade through the complicated interactions of state laws and regulations. This would lead to greater competition which would only benefit the American consumer.

Facing a single regulator would also provide a more streamlined process for the introduction of new insurance products. With a federal charter, insurers would need the approval of only one regulator, rather than fifty-one separate ones. This would allow insurers to bring new

products to market more quickly and would better serve consumers by removing delay and waste in the regulatory approval process.

### **III. CONCLUSION**

The insurance industry faces new risks and new challenges. To address those risks, industry and government must rethink the way they do business. The industry must develop new tools for risk management and find ways to increase its capacity to meet the demand of policyholders and consumers. The government must rethink its rules and procedures. Does the current regulatory system serve the needs of the American insurance consumer? In many ways, it does not. Government must make it easier for the industry to pursue innovation and must reform or remove rules and regulations that inhibit such innovation. The government must likewise removing accounting regulations that block insurers' ability to insure against catastrophic risks and reform the system so that it provides financial incentives to the industry to expand its capacity to insure such risks. Government should modernize the current regulatory system and give serious consideration to proposals such as those before Congress that would create optional federal charters. Finally, government and the industry must come to terms with terrorism risk and together work out a permanent solution that makes the best use of the capabilities and expertise of each.