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The risk of loss from repeated, large-scale terrorist attacks does not presently appear great enough to make terrorism largely uninsurable. Although some federal action may be desirable to guard against a potential crisis in property/casualty insurance markets if the risk of loss escalates, appropriate action should encourage private sector risk spreading and consider the costs of subsidies, including their adverse effects on private incentives to control losses and settle claims efficiently.

Insurance involves a fundamental tension between risk sharing and incentives. The benefits of risk sharing are widely appreciated. Moral hazard – the dulling of incentives to reduce risky activity and take precautions to control loss that often accompanies insurance – is less visible. Private insurance premiums reflect each policyholder's risk of loss, thus reducing moral hazard. Insurers that fail to price policies accurately in relation to the buyer's risk of loss suffer adverse selection: they attract a disproportionate number of buyers at inadequate rates. Those insurers lose money and either learn or disappear. Private insurers also have strong incentives to settle claims efficiently.

Government insurance invariably results in subsidized rates that are crudely related to the risk of loss, thus aggravating moral hazard and adverse selection.

Incentives for efficient claim settlement are relatively weak compared with private insurance. Mandating the purchase of coverage can mitigate adverse selection (it has kept social security from unraveling), but mandates are unpopular. In federal crop and flood insurance, a disproportionate number of high-risk entities are insured at inadequate rates, thus requiring large taxpayer subsidies. Private insurers that market federal crop insurance have vigorously expanded supply with government encouragement. Federal insurance programs tend to lose money and expand, crowding out viable private sector coverage. Risky activity and the amount of losses tend to increase as parties adapt to the terms of subsidized coverage.

Subsidized federal reinsurance, or direct federal reimbursement of terrorism losses, could make citizens more vulnerable to harm by discouraging rational responses to increased risk following September's attacks. Consider the question: Will businesses take the same precautions to protect life and property if insurance against terrorist attacks is made available at substantially lower cost due to federally subsidized reinsurance or direct federal reimbursement of loss?

While the Administration's proposal would avoid creating a complex, new entity that would displace private insurer risk assessment, it would require substantial subsidies to insurers and large, commercial property owners. Federal reimbursement of terrorist losses on essentially a first dollar basis is not needed and would be counter-productive. It would seriously undermine the integrity or risk management, risk assessment, and claims adjustment. While the suggested thresholds and percentages for federal reimbursement increase materially after the first year, the proposal would do nothing to encourage private insurers to increase capital and their underlying ability to bear risk.

A two-pronged approach would significantly mitigate funding problems and therefore promote greater private market risk spreading – without requiring large subsidies and displacing private market pricing and risk assessment. First, allow insurers and reinsurers to accumulate some amount of capital (reserves) on a tax-deferred basis. Corporate income taxes on insurers' investment income significantly increase the premium rates needed to cover the costs of holding the large amounts of capital necessary to insure potentially large losses, whether natural or man-made. Tax deferral has previously been proposed for insurance against large losses from natural catastrophes. It is permitted for existing state government catastrophe reinsurance mechanisms. Reducing the tax on insurers' capital would expand private sector capacity to insure potentially large losses from terrorism. Tax deferral would make terrorism coverage cheaper and more abundant.

Second, consider authorizing a temporary system of ex post assessments to help private insurers spread the risk of loss from terrorist attacks. If annual losses from terrorism exceeded an initial threshold, such as $10 billion, all property/casualty insurers could be assessed a percentage of their premiums to finance a material proportion of excess losses. Carriers that wrote the underlying policies would pay the remainder. If annual assessments reached a specified limit, such as 2 percent of premiums, insurers could be allowed to borrow from the Treasury to finance additional assessments. Any loans could be repaid with future assessments. Establishment of a second and much higher threshold also might be considered, above which the federal government would share directly in additional losses.

With this approach, insurers and reinsurers would negotiate contracts that reflect broader risk spreading and the probabilities of being assessed. The risk to taxpayers would be low. The risk of assessments would be manageable by insurers and would influence competitively determined premium rates. If necessary to address concerns that price regulation in some states might prevent that result, direct assessments of policyholders could be authorized.

The tax incentive / ex post assessment approach would significantly mitigate the inherent problems of funding potentially large losses from terrorism. Compared to creation of a federally backed reinsurer or direct federal reimbursement of losses from terrorism, insurers could achieve additional risk spreading without large subsidies and without materially undermining the integrity of private sector risk assessment, claims settlement, and risk management. The results could include less loss of life and property.