NATIONAL REVIEW

How Not to Address Terrorism

Let the Terrorism Risk Insurance Act expire.

By Mark Calabria
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House Republicans and Senate Democrats are in the midst of negotiating a deal to extend the Terrorism Risk Insurance Act (TRIA), which expires at the end of this year. They should save themselves the trouble and protect the taxpayer by allowing TRIA to expire. TRIA is no more than corporate welfare wrapped up in the flag. If anything, it has the potential to increase losses from a terrorist attack rather than reduce them, as industry claims.

TRIA is simply a mechanism for allocating the losses from a terrorist attack. It does nothing to deter terrorists. Do we truly believe that terrorists say to each other, "Let's not attack that building, it's insured"? Under the best of circumstances, TRIA has zero impact on the cost of a terror attack. To justify TRIA, one must demonstrate why the taxpayer instead of market participants should bear its costs.

TRIA, like all insurance, is about the pooling and sharing of risk. The most likely physical targets of TRIA would be either public buildings or trophy commercial properties, like the World Trade Center. In the case of public buildings, the public already backstops these properties.

With private commercial properties, there are many possible mechanisms. For instance, a REIT (real-estate investment trust) structure provides a ready avenue for spreading the risk of losses that may result from terrorism. A REIT by its very nature is a diversified vehicle for spreading risk. A common form of risk-sharing is the publicly traded corporation. As most trophy commercial properties are owned by publicly traded corporations, the risk of loss from a terror attack is already spread out across shareholders. Again, the argument must be: Why are taxpayers thought to be better able to bear that risk than shareholders in publicly traded corporations, given the concentrated holdings of corporate equity? Why should middle-class taxpayers subsidize the 1 percent?

The same holds for defenses of TRIA based on workers' compensation. Let us not forget that the workers' compensation system is already an insurance system. You don't need TRIA as an avenue for pooling terrorism-related workers' compensation risk. The workers' compensation program is already set up to do so. Does that mean some employers would see their premiums go up? Perhaps, but again, why should the taxpayers bear this risk instead of employers? There's no free lunch here, just the allocation of losses.

It would be bad enough if TRIA simply redistributed losses from corporate America to taxpayers, but TRIA runs the risk of *increasing* the losses from terrorism. If developers faced the full cost of their design choices — say, that between a glass building façade or reinforced concrete – they would build safer structures. We've sadly seen this play out in the national flood-insurance program, where subsidies have encouraged poor construction while also encouraging families to live in harm's way. Even the Congressional Budget Office has acknowledged that TRIA lessens the incentives to reduce losses from a terror attack. Let's hope we never find out.

Facing the full costs of their choices, companies may well choose to locate their activities elsewhere. That's a good thing, as it reduces the potential losses from a terror attack. Arguments that commercial construction would come to a halt without TRIA are simply absurd. The absence of TRIA may well force changes in leverage, design, or the location of real-estate transactions, but these are appropriate responses and should be welcomed.

Perhaps the most important lesson of the financial crisis was that when you underprice risk, people make poor choices. That has been repeatedly demonstrated when Congress has attempted to hide the costs of certain activities, like subprime-mortgage lending. Similarly distorting the pricing of terrorism risk will also lead to poor choices.

The insurance industry's initial reaction to 9/11 was the correct one: have states allow for the exclusion of coverage for terrorism, as it is excluded for damages resulting from wars. The obstacle was that California, Florida, Georgia, New York, and Texas would not provide such exclusions. While I am reluctant to see preemption of state insurance laws, the creation of TRIA has dragged the federal government into this field and therefore demands a national solution.

A simple fix would be for the federal government to allow for an exclusion of terrorism coverage nationwide. These few states are significant enough to form their own voluntary risk pools. If Florida can establish a state-run homeowner's insurance fund, then surely New York can form a state terrorism-risk pool without federal involvement or backing.

Short of ending TRIA, Congress should at a minimum increase the losses required to be borne by the insurance industry before TRIA kicks in. There's tremendous capacity today in both the primary and the re-insurance markets. Similar to catastrophic-risk bonds, other capital-market solutions to sharing terror risk can be developed once the federal government gets out of the way.

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