

➤ **A Soft Look at Hard Fraud**

Given all of the recent shenanigans within the insurance industry, I had to chuckle when I saw the March/April issue of *Contingencies* devoted to so-called soft fraud. Was this intended as the April Fools' edition? The cover leads off with a caricature of a little old lady attempting to swindle a poor insurance professional. Inside Track then treats us to the story of bumbling Jose who files the same claim three times and is finally arrested for insurance fraud. (It's funny how perpetrators of insurance fraud often have names like Jose; never Ronald or Maurice.) A crack team of actuaries then profess the need for "lots and lots of data" (and presumably many, many billable hours) in order to identify those claimants with impure intentions lurking within their hearts.

Meanwhile, the *Washington Post* of Feb. 3, 2006, reports, "Three former top executives of General Re Corp. were indicted yesterday on charges they helped insurance giant American International Group Inc. cook its books by engineering a phony reinsurance deal." It seems like "A Soft Look at Hard Fraud" would have been a better title for your recent issue.

KEVIN MOYNIHAN
ST. PAUL, MINN.

➤ **Who Should Pick Up the Tab?**

The intent of this letter is to question whether the Academy truly has added substance to the discussions surrounding the extension of the Terrorism Risk Insurance Act (TRIA). Michael G. McCarter, in a commentary entitled "Making Good Sausage" in the March/April 2006 *Contingencies*, wrote: "It [the Academy's Dec. 2, 2005, public statement] did express the basis for our conclusion that some sort of federal legislation was necessary if terrorism insurance were to be widely and readily available..."

In the Casualty News section of the January 2006 *Actuarial Update*, in an article entitled "Academy Adds Substance to TRIA Debate," it was asserted that the Academy provided "independent and objective analysis" to Congress with respect to the extension of TRIA. The Academy concluded that "permanent federal legislation [is] necessary in order to make terrorism coverage widely and readily available."



I submit that the Academy, rather than providing a substantive actuarial analysis, has instead made a statement of political opinion. Implicit in the Academy's conclusion regarding federal legislation are the following elements:

- Owners of property demand terrorism coverage;
- Owners of property should have their demands met;
- The market can't or won't provide the desired coverage; therefore
- The government should use its coercive power to force taxpayers to accept a risk (or finance a risk) that the market can't or won't.

Property owners decide to insure their property against various perils by assessing the benefit and the cost of insuring. If the benefit appears to outweigh the cost, they'll purchase insurance. If not, then insurance will be declined, and the property owner will retain the risks associated with owning the property.

With regard to the risk of terrorism, it's often argued that (1) the cost of insurance for this peril is too high, and (2) the amount of capacity available in the market is too low. This argument fails a test of basic economics.

First, there is no "correct" price for any economic good. There is only the price at which parties will transact. When one party argues that a price is too high, it simply means it's unwilling to purchase the economic good at the price offered by the owner of the good. There is no objective

way to determine whether a price is fair. A party complaining about a price being too high is simply stating that it can't afford to pay the price set by the market.

Second, the argument is self-contradictory. If the price to insure against the risk of terrorism were truly too high, then there would be no shortage of capacity. In the absence of interference in the market (which almost always comes from government), capital would flow into the market to take advantage of this great pricing.

There is no harm in having property owners retain the risk of terrorism. All investments carry risk. Riskier investments produce higher returns. Although it can be argued that the federal government has an obligation to defend the nation against terrorist attacks, it's difficult to find a constitutional mandate to lower property owners' investment risks by insuring against those attacks or by forcing taxpayers to finance an industry. I argue that property owners can and should bear the risks associated with ownership of their property.

It's unfortunate that the Academy has reached the conclusion that the inability or unwillingness of property owners to pay the market price for terrorism coverage means that taxpayers must be forced to offer the coverage at below-market prices. Too often, the conclusion that government must be involved in solving a perceived problem is simply a substitute for rigorous thinking, and I fear the Academy stands guilty of this. (To be fair, Mr. McCarter does acknowledge the government's role in hampering market development by mandating terrorism coverage in certain lines).

We must keep in mind that taxes are paid because the government has coercive power, employing sheriffs, marshals, revenue agents, police, and soldiers. In effect, the Academy's contribution to the TRIA debate has been simply to affirm the government's use of its coercive power to provide cheaper insurance. This should not be seen as adding actuarial substance to the TRIA debate; instead, I submit it should be seen as adding political bias to the debate, a bias not necessarily endorsed by the members.

DONALD SOLOW
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➤ **Mike McCarter responds:**

I read Mr. Solow's letter with considerable concern. Could the American Academy of Actuaries, and more specifically, could an Academy subgroup I've had the privilege of chairing, actually have called for the "government to use its coercive power to force taxpayers to accept a risk (or finance a risk) that the market can't or won't"?

Frankly, I thought I would have noticed if our subgroup had made such a demand. And if I'd been nodding, I certainly thought the Academy peer, policy, and various other reviewers would have pulled us up short. After all, we've read a thousand times that the first part of the Academy's mission is "to assist in the formulation of public policy by providing independent and objective information, analysis, and education." Calling on the government to use its coercive taxing powers for the benefit of property owners and insurers hardly seems consistent with such a mission.

I rushed to review our public statement of Dec. 1, 2005 to see where this deplorable call for a taxpayer bailout of the insurance industry had crept in. Mr. Solow, I'm happy (and relieved) to report to you

that our statement calls for no such thing. I note in your letter such phrases as "implicit in the Academy's conclusion" and "it is often argued that." Remarkably, these phrases precede accounts of arguments that the Academy never made.

Let me highlight a few key points that we did make:

- Quantification of policyholder and insurer terrorism exposure is difficult.
- Terrorists with access to weapons of mass destruction could cause insured losses of \$700 billion or more.
- If no national framework for terrorism insurance exists, the insurance industry could be exposed to potential insured losses from terrorism far in excess of those it can sustain without significantly damaging its ability to provide the ongoing insurance coverage that's important to the efficient functioning of our economy.
- Sufficient private reinsurance to protect insurer capital from such perils is unavailable now and unlikely to be available in the foreseeable future.

And, to give Mr. Solow his due, there is a key point that was only implicit in the Academy's public statement of last De-

cember, but which was made explicit in my *Contingencies* commentary and in the Academy's testimony to the NAIC terrorism public hearing in March. That is: Workers' compensation insurers are unable to control accumulations of terrorism exposure except by avoiding writing the underlying risk. Group life insurers face a very similar situation.

In fact, nearly \$500 billion of the \$700 billion of insured losses we estimated that could be caused by a large chemical, nuclear, biological or radiological (CNBR) attack on New York City came from workers' compensation.

Implicit in Mr. Solow's argument is the idea that insurers could simply stop writing workers' compensation if they're uncomfortable with the terrorism risk that comes with it. One could even leave the insurance business entirely. But any insurers who remain will find that the departure of voluntary workers' compensation carriers will massively increase their share of the residual market for that coverage, magnifying each remaining insurer's exposure to terrorism risk.

The Academy subgroup believes that a vibrant insurance marketplace is in the best interest of the consumers and businesses that make up our nation's economy. In this age of exposure to terrorism, the subgroup's analysis shows that maintaining such a vibrant insurance marketplace requires a national framework for dealing with terrorism risk.

The Academy has not advocated a specific national framework, except to call for an extension of TRIA to allow time for a more permanent framework to be developed. The subgroup is now working hard to provide input to the president's Working Group on Financial Markets so that policy-makers have the best available information on which to make their decisions.

Unfortunately, what we've found is that modern technology gives terrorists the potential to unleash acts of what amounts to war, even though no nation-state was involved in pulling the trigger. War exclusions have long been common in insurance contracts. Now we need some way of dealing with terrorists' acts of similar magnitude.

MICHAEL MCCARTER
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