Government-Sponsored Enterprises and the Post-TRIA Regime

by B. Gerard Cordelli

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One of the more significant and controversial aspects of both the Terrorism Risk Insurance Act (TRIA) program and any currently envisioned successor regime is the involvement of the federal government as an adjunct, or "backstop," to private industry in providing terrorism risk insurance. That involvement in the existing TRIA scheme is significant, of course, because without it there would be little or no availability of terrorism risk coverage generally in the United States market, at least in the near term. The controversy comes because there is wariness in many quarters, including both Congress and the Administration, over the involvement of the federal government in what is normally a private sector commercial endeavor (*i.e.*, insurance of risk, if not of terrorism risk in particular). This unease extends both to the potential need to use taxpayer dollars, and to the bureaucratic entanglements of the regulatory regime that can follow the displacement of a private sector function, albeit even if only temporarily.

One possible approach to the post-TRIA environment may be the involvement of a government-sponsored enterprise (GSE) with a mission to both stabilize, and increase, the amount and availability of capital for use in insuring or otherwise transferring the risk of loss attendant to terrorism events from individuals and businesses to those willing to bear that risk for a fee. This White Paper examines, in brief, how GSEs have been used in the financial services sector in the past to promote goals seen to be in the public interest, without "direct" government backing. It will seek to outline what lessons that experience might provide for consideration in the debate about a successor to TRIA, and what is widely presumed to be a necessary federal government involvement of some kind and/or degree.

It should be noted that some of the GSEs discussed in this paper have become *de facto* "best practices" standards setters with respect to certain aspects of the underlying market sectors they serve. Moreover, some have expanded their roles, of necessity, and/or by dint of experience, to areas "vertically" related to their primary missions of providing, expanding, or stabilizing capital flows. This is a factor to consider in examining the usefulness of the GSE model in responding to what is a comparatively new, and potentially ruinous, type of exposure that is still being digested by risk management departments and professionals, both nationally and globally.

Special considerations regarding subrogation recoveries against aiders and abettors of terrorism that result in losses insured under a post-TRIA regime are examined as well. The paper will also touch upon some of the obstacles to any efforts by insurers (or, as posited, a GSE) seeking subrogation recoveries after paying a terrorism loss. Although not intended to be a monograph, nor even especially cohesive, the paper also points out various developments that strike the author as potentially relevant in this regard. At a minimum, they are matters that may be considered by whatever entity or group it is that fills the role currently played by the federal government under TRIA.

I. What is a Government-Sponsored Enterprise?

A Government-Sponsored Enterprise (GSE), broadly speaking, is a stockholder owned and operated corporation, chartered by the federal government, with a specific mission that it is obligated to serve. Generally, the mission is one thought to further a public good in an area already the subject of some government involvement. Moreover, that public good is usually one that the private sector has served either imperfectly, or not in sufficiently robust a fashion so as to ensure the accomplishment of particular national imperatives.

Although a GSE charter will grant an entity certain advantages over private corporations serving the same market—generally perceived to at least extend to a "funding advantage" over purely private corporations—neither its obligations nor its products or services enjoy any official government backing. Moreover, its charter will

tend to limit the activities in which it can engage, in comparison to private sector participants in the same "market." In contrast, a GSE will tend to have a greater freedom to engage in certain transactions than will a purely government entity serving the same market, or pursuing a similar mission.

The White Paper will now describe the history and operation of several GSEs: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Student Loan Marketing Association (Sallie Mae), the Federal Agricultural Mortgage Corporation (Farmer Mac), and the Government National Mortgage Association (Ginnie Mae).

Information regarding Fannie Mae, Freddie Mac, Sallie Mae, Farmer Mac, and Ginnie Mae history and operations is taken, in part, from the web sites for each of these organizations. Fannie Mae receives the most extensive treatment in this White Paper for a number of reasons, both functional and practical: it is the largest of the GSEs; the oldest, it has gone through the most visible evolution and, of late, regulatory scrutiny; and, its web site contains the most detailed and accessible information on its history and operations.

A. Fannie Mae

The Federal National Mortgage Association ("Fannie Mae") purchases mortgage loans from mortgage companies, savings institutions, credit unions, and commercial banks. It either packages the loans into mortgage-backed securities (MBS), which it guarantees for full and timely payment of principal and interest, or it purchases the loans for cash, and retains the mortgages in its own portfolio. According to the Fannie Mae web site, since 1968 it has provided more than 61 million homeowners with more than $6 trillion in housing finance. Furthermore, Fannie Mae credits its efforts with producing, for the first time, the widespread availability of low down payment mortgages for lower income families.

1. Fannie Mae's History

Fannie Mae was created on February 10, 1938, by the Federal Housing Administrator, acting under Title III of the National Housing Act (NHA), found at 12 U.S.C. §1716 *et seq.*, which concerns what are referred to as the National Mortgage Associations. Section 301 of Title III, captioned National Mortgage Association Purposes, provides as follows (subpart (5), *in italics*, is applicable only to Fannie Mae's government agency analogue, Ginnie Mae):

> The Congress hereby declares that the purposes of this title are to establish secondary market facilities for residential mortgages, to provide that the operations thereof shall be financed by private capital to the maximum extent feasible, and to authorize such facilities to—
>
> (1) provide stability in the secondary market for residential mortgages;
>
> (2) respond appropriately to the private capital markets;
>
> (3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
>
> (4) promote access to mortgage credit throughout the Nation (including central cities, rural areas, and under served areas) by increasing the liquidity of mortgage investments in improving the distribution of investment capital available for residential mortgage financing; and

(5) *manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government.*

The association was originally called the National Mortgage Association of Washington, but its name was changed to the Federal National Mortgage Association later in 1938. Initially, Fannie Mae was only authorized to buy mortgages insured by the Federal Housing Administration (FHA). In 1944, its purchasing authority was expanded to include loans guaranteed by the Veterans Administration (VA) which, in the post-World War II era, increased in significance as a class of mortgages.

In 1948, Fannie Mae was chartered by Congress, and in 1954, Congress re-chartered Fannie Mae under the so-called Charter Act, which still provides the basic framework under which Fannie Mae operates today. Pursuant to the Charter Act, Fannie Mae was authorized to conduct secondary market operations in mortgages insured by the FHA, or insured or guaranteed by the VA. It was also authorized to perform special assistance functions in the purchase of mortgages, and to manage and liquidate certain mortgages. The Charter Act also provided for Fannie Mae to become a "mixed-ownership" corporation owned partly by private stockholders.

The 1954 Charter Act removed government backing for borrowings used to fund Fannie Mae's secondary market operations, and exempted Fannie Mae from all local taxes other than property taxes. Moreover, it provided for the Federal Reserve Bank to perform various services for Fannie Mae, and provided access to a line of credit with the United States Treasury. It did not, however, remove Fannie Mae from direct federal control. The Charter Act also outlined the way in which Fannie Mae's secondary market operations would be transferred to the private sector. To wit, proceeds from gradual sales of common stock were to be used to retire Treasury-owned preferred stock in Fannie Mae. At this point, however, Fannie Mae stock was not listed on any publicly traded exchange.

Effective in 1968, Fannie Mae was partitioned into two separate entities, Ginnie Mae and Fannie Mae. Ginnie Mae continued as a federal agency, and was responsible for the then-existing liquidation and special assistance programs, while Fannie Mae moved further along the path of a GSE, with responsibility for self-supporting secondary market operations. In fact, Fannie Mae retired the last of its government stock on September 30, 1968, and the transformation to a fully functional GSE was completed in 1970. Another important feature of the 1968 amendments to the Charter Act was the provision of authority to Fannie Mae for the issuance of mortgage-backed securities (MBS). The Act also established the fundamental regulatory structure to ensure that Fannie Mae adhered to its public purpose. It provided for continuing oversight by the Department of Housing and Urban Development, granting HUD "general regulatory power… to insure that the purposes of this title are accomplished."

The Emergency Home Finance Act of 1970 (EHFA) created Fannie Mae's smaller "cousin," Freddie Mac, which was allowed to operate in the conventional mortgage market, and is discussed further below. At the same time, parallel authority for and limitations on dealing in conventional mortgages was also granted to Fannie Mae. Moreover, at this time, Fannie Mae began being listed on the New York and Pacific Stock Exchanges, under the designation FNM.

Since both Fannie Mae and Freddie Mac were being authorized to acquire conventional mortgages that lacked federal backing or federal insurance, several eligibility restrictions and/or risk-sharing requirements were imposed on the mortgages that the "cousins" could purchase. Moreover, the Secretary of HUD was required to provide prior approval of any "purchase" or "dealing in" conventional mortgages, a regulation ultimately interpreted to refer only to specific approval for new and different conventional programs. This regulatory mandate has tended to have a strong influence on the entire conventional mortgage market, regardless

of whether individual such loans are purchased by Fannie Mae or Freddie Mac, as the "cousins" constitute the dominant portion of the secondary mortgage market for conventional loans.

Reflecting the somewhat methodical nature of the evolution of this enterprise, Fannie Mae did not make its first conventional mortgage purchase until February 15, 1972, two years after being granted that authority. The movement toward the truly national secondary market for conventional mortgages, now a commonly accepted part of the mortgage and housing industry, had begun in earnest. By 1976, in fact, Fannie Mae was purchasing more conventional loans than FHA and VA loans. Incremental expansions of the types of loans in its portfolio continued thereafter, and in 1978, the conventional mortgage program expanded to include the purchase of two-to-four family home loans. Thereafter, in 1981, Fannie Mae began purchasing adjustable-rate mortgages (ARMs) and second mortgages, and introduced its own MBS business. In 1983, Fannie Mae added conventional multi-family housing loans to the list of mortgages that it would purchase.

In 1984, in what can be described as a typical chapter in the continuing interplay between regulatory authorities and developments in the marketplace in which Fannie Mae participated, the Secondary Mortgage Market Enhancement Act (SMMEA) of 1984 became law. Its ostensible purpose was to clarify and modify several of the regulatory powers HUD had over Fannie Mae. Among other things, it required HUD to respond within 45 days to any request for new program approval made by Fannie Mae. It also "authorized" Fannie Mae to purchase and deal in subordinate lien mortgages, something that it already had been doing to some extent since 1981.

In another significant milestone in 1984, Fannie Mae issued its first debenture in the Euromarket, marking the beginning of its foray into foreign capital markets. This was not a temporary phenomenon, and remains a significant feature of Fannie Mae's efforts to raise the debt necessary to fund its massive operations. In 1987 Fannie Mae issued its first Real Estate Mortgage Investment Conduits (REMIC). In 1988, 18 years after its debut, Fannie Mae stock was added to the Standard & Poor's 500 index, cementing its place as one of the larger financial services sector players in the nation.

The Financial Institutions Reform Recovery and Enforcement Act (FIRREA) of 1989 made the regulation of Fannie Mae and Freddie Mac consistent. Moreover, as a reflection of growing concern over the potential exposure to the federal government posed by what many viewed as the arcane field of so-called "derivative instruments," the General Accounting Office (GAO) and Treasury Department were instructed to conduct studies of Fannie Mae and Freddie Mac, as well as of the Federal Home Loan Mortgage System. This desire for further studies of Fannie and Freddie also likely reflected a concern by private sector competitors in the conventional market of the increasing size and power of each. Concomitantly, it also reflected a growing concern by both competitors and consumer advocates as to whether each was serving the public mission well enough to continue warranting the advantages granted these private concerns by their GSE status. In 1991, Fannie Mae announced a $10 billion initiative entitled "opening doors to affordable housing," in part as a response to this criticism. According to Fannie Mae, in July of 1993, it had produced that $10 billion in purchases of low, moderate income, and other special housing units, 16 months ahead of schedule.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA) began a change in the regulatory oversight of Fannie Mae and Freddie Mac. It created a new regulatory office within HUD, entitled the Office of Federal Housing Enterprise Oversight (OFHEO), with responsibility for ensuring that Fannie and Freddie were adequately capitalized and operated safely. In a practice common in other financial services sectors that are heavily regulated, OFHEO is funded by assessments on Fannie Mae and Freddie Mac. In addition, it is authorized to act without HUD oversight with respect to a number of issues enumerated in the statute. In particular, the Act established risk-based and minimum capital standards for Fannie and Freddie. Moreover, it established HUD-imposed housing goals for the financing of affordable housing and housing in central cities, rural areas, and

other underserved areas. Also in 1992, Fannie Mae became, for the first time, the largest issuer and guarantor of mortgage-backed securities, surpassing both Ginnie Mae and Freddie Mac.

In 1994, Fannie Mae announced the expansion of its "opening doors" campaign, pledging $1 trillion in targeted housing finance to serve 10 million low to moderate-income families. In April of 1998, Fannie Mae announced the national availability of a new mortgage product that provided for a 3 percent down payment requirement. The following year, 1999, saw the first of a relatively rapid series of increases in the conventional loan limit, to $240,000. That limit was to increase again the following year to $252,700, and was followed by increases to $275,000 (2001), $300,700 (2002) and $322,700 (2003). Thus, in the space of four years, the conventional loan limit had increased approximately $100,000. Although there are certainly areas of the nation where a $322,700 limit is necessary in order to fund a "moderate income" home purchase, for much of the country, this amount was in excess of the median home price. As such, it attracted additional criticism of the funding and other advantages enjoyed by these GSEs, supposedly in service of their mission to make low and moderate-income housing more affordable. No doubt such criticisms were in mind as Fannie Mae announced its "American Dream" commitment in 2001, a ten-year, $2 trillion pledge to increase home ownership rates and serve 18 million American families.

In 2002, in an effort to meet growing demands for increased transparency in financial disclosures, Fannie Mae announced that it would voluntarily register its common stock with the SEC, and file periodic financial and current event disclosures on an ongoing, required basis, starting in 2003. Moreover, CEO Franklin Raines and CFO Tim Howard voluntarily followed SEC Order No. 4-460 by certifying the company's most recent periodic financial reports. In 2003, as announced, Fannie Mae voluntarily registered its common stock under Section 12 (g) of the Securities Exchange Act of 1934. In addition, Fannie Mae increased its mortgage-backed securities (MBS) disclosures, with much of the information being made available through its corporate web site. The recent report of the results of an exhaustive examination of Fannie Mae's accounting practices by OFHEO suggests that its regulator has a sharply different view of how well Fannie Mae has succeeded in this regard. It is unclear at this point whether the problems identified by OFHEO are limited primarily to the "smoothing" of earnings through the use of "cookie jar" reserves and improper timing of expense recognition to ensure executives bonuses, or whether more fundamental structural problems exist with respect to the firm's entire method of operation.

Fannie Mae is currently one of the largest financial services corporations in the world, and employs over 5,000 people. As Fannie Mae likes to point out, it receives no government funding or backing and, despite its tax breaks, is, in fact, one of the nation's largest taxpayers. It remains to be seen whether Fannie Mae will go the route of fellow GSE, Sallie Mae, and become a fully privatized corporation. Arguably, the same conditions that prevail in the student loan market—where a substantial portion of the money lent to students is still federally insured or guaranteed—do not necessarily prevail in the conventional mortgage market, which is not served by Ginnie Mae, nor otherwise the subject of government guarantees. Moreover, Fannie's voluntary submission to regulatory requirements that most private corporations routinely meet was likely designed to forestall the severance of all of its advantageous ties to the federal government. However, in light of the findings of the recent OFHEO report and the obvious tension between Fannie Mae and its regulator, it is possible that the firm's future form and structure may not be something Fannie has the option of choosing itself.

2. Fannie Mae's Operations

Fannie Mae issues two categories of securities—debt securities and mortgage-backed securities. Its two primary lines of business are portfolio investment, which consists of the purchase of mortgages and mortgage-backed securities as investments funded with debt, and credit guaranty, where it guarantees the credit performance of single-family and multifamily loans for a fee. The latter involves no backing by the U.S. gov-

ernment, however, and is based solely on the financial health of Fannie Mae itself. Fannie Mae is, in fact, one of the world's largest issuers of debt securities, and is the leader in the $5 trillion U.S. home mortgage market. As noted above, Fannie Mae issues debt in both the domestic and global capital markets, and it offers a bewildering array of debt securities, with a wide range of maturities.

Fannie Mae contends that the nature of its mission requires a continuous need for large amounts of funding, which Fannie suggests effectively precludes it from issuing debt opportunistically, for short-term gain, at the expense of its investors. Although Fannie Mae is hardly the only Fortune 500 corporation espousing a business model that purports to take such a long-term approach, it does have a statutory mission to fulfill, a factor not present for private corporations in its field. Partly as a result of this circumstance, Fannie Mae's debt obligations are treated as U.S. agency securities in the marketplace, putting them just below United States Treasuries, and just above AAA corporate debt. Fannie Mae openly admits that such favorable treatment is due, in part, to its status as a GSE, the public mission that it serves, and its continuing ties to the U.S. government.

In addition to the favorable view the private market has of Fannie Mae's debt obligations from a credit-worthiness perspective, they also receive favorable treatment from a regulatory perspective. Among other things, Fannie Mae securities are "exempted securities" under relevant SEC laws to the same extent as U.S. government obligations. In addition, Fannie Mae debt qualifies for more liberal treatment than corporate debt under various federal statutes and regulations, and to a limited extent, foreign statutes and regulations. This makes it possible for deposit-taking institutions to invest in Fannie Mae debt more heavily and easily than equity and corporate debt, or mortgage-backed and asset-backed securities. A further feature of such favorable regulatory treatment is that certain institutions can invest in Fannie Mae debt on a par with obligations of the U.S. government, and in unlimited amounts.

In fact, Fannie Mae's debt securities are generally purchased by institutional investors, such as commercial bank portfolios, trust departments, investment fund managers, insurance companies, pension funds, state and local governments, and central banks. Indeed, in what seems a now-distant past, when the United States Treasury was looking at a surplus approaching $1 trillion, the debt instruments of Fannie and Freddie were one vehicle being considered for the investment of such surpluses. These debt securities are sold by a select group of securities dealers and dealer banks, many of which also sell U.S. Treasury obligations, through a variety of negotiated and underwritten methods.

Fannie Mae issues a variety of different types of debt securities, with both short-term and long-term maturities, either callable or non-callable. Fannie Mae's non-callable debt securities are particularly attractive to investors, due to their liquidity, price transparency, and spread advantage versus comparable maturity Treasuries. Fannie Mae also credits itself with the creation of the U.S. agency callable debt market in 1987. Given the interest rate risk inherent in holding a mortgage portfolio subject to prepayment from underlying borrowers—a particular risk in periods such as the recent past, with its historically low interest rates—it is virtually a necessity that Fannie Mae issue significant callable debt, to ensure that the durations of their liabilities and mortgage assets closely coincide. As Fannie Mae characterizes it, they are effectively buying a call option from investors, and compensating them with additional yield above comparable maturity non-callable debt.

Some Fannie Mae debt securities are also eligible for stripping into principal and interest components, through the Federal Reserve Book Entry System. They also offer structured notes with various step up, variable rate, and zero coupon securities. Most such issues are added in response to specific investor demand. Fannie Mae also has variable-rate securities, which can be callable or non-callable, including simple index, various customized calculated indices, and a complex calculated index, with cross-currency dual indexing. In short, given its heavy dependence on debt funding for its operations, it strives to present as wide a variety of potential investments as possible.

B. Freddie Mac

The Emergency Home Finance Act of 1970 (EHFA) created Freddie Mac. It was authorized to create a secondary market for conventional mortgages, and assist in the existing efforts to increase the supply of funds generally available for homebuyers and multi-family investors. Like Fannie, its primary business is the purchase of mortgages from lenders, the packaging of those mortgages into securities, and the selling of securities, guaranteed by Freddie Mac, to investors. As with Fannie, the secondary mortgage market Freddie Mac offers to lenders allows them to fund new mortgages after they have sold their initial mortgages to Freddie Mac.

Both Fannie Mae and Freddie Mac have a backup credit line with the United States Treasury. Federal law allows the Secretary of the Treasury to purchase up to $2,250,000,000 in GSE obligations. The Treasury has never exercised this discretionary borrowing authority in Freddie Mac's 33-year history. Nonetheless, Freddie Mac acknowledges that its federal charter and the line of credit with the Treasury cause many investors to feel that Freddie Mac is more creditworthy than other private firms. As such, they obtain a funding advantage that allows them to borrow money at rates more favorable than the rates offered to other firms.

1. Freddie Mac's History and Regulation

As noted above, in 1989 FIRREA made the regulation of Fannie Mae and Freddie Mac consistent. Prior to 1989, Freddie Mac was owned by the Federal Home Loan Bank System and its member thrifts, and governed by the Federal Home Loan Bank Board, which would later be reorganized into the Office of Thrift Supervision (OTS). The Act severed Freddie Mac's ties to the Federal Home Loan Bank System, however, and created an 18-member Board of Directors to run Freddie Mac, subject to HUD oversight.

The creation of the Office of Federal Housing Enterprises Oversight (OFHEO) in 1992 served to introduce a special regulatory body responsible for ensuring the fiscal stability of both Freddie and Fannie. While OFHEO is located within HUD organizationally, it operates independently of the Secretary of HUD as it implements, monitors, and enforces capital standards for Freddie and Fannie, in an arrangement OFHEO compares to how the Office of Comptroller of Currency operates within the Treasury Department. In view of their size and importance to the mortgage markets, and the scope and complexity of their operations, this was a task thought to be sufficiently important and specialized to require more expertise than was available within the existing HUD administrative structure.

According to OFHEO, combined assets and off-balance sheet obligations of Fannie Mae and Freddie Mac were more than $2.4 trillion at the end of 2000. Pursuant to that office's oversight responsibilities, it has developed a risk-based capital standard, using a "stress test" that simulates stressful interest rate and credit risk scenarios, which it then applies to the enormous balance sheets of both Fannie Mae and Freddie Mac. OFHEO also makes quarterly findings as to capital adequacy based on minimum capital standards and a risk-based capital standard, prohibits excessive executive compensation, issues regulations concerning capital and enforcement standards, and takes necessary enforcement actions.

More recently, OFHEO came under critical fire for having attested to the "soundness" of Freddie Mac's financial controls just prior to the announcement by Freddie in 2003 that it may have understated its earnings by as much as $5 billion over the past several years. This revelation led OFHEO to conduct an even more intensive examination of Freddie Mac than it had done previously, documented in a 200-page report issued in December of 2003. This was followed by a $125 million civil penalty, accompanied by a consent order requiring compliance with 28 internal and board level tasks designed to address the problems revealed. OFHEO also asked that the chairman and CEO functions be separated within a reasonable period of time. Then, in January 2004, OFHEO issued an order requiring Freddie to maintain a mandatory target capital surplus of thirty per-

cent over the minimum capital requirements otherwise determined by OFHEO. Further corporate transactions were added to the list of things for which OFHEO's prior approval had to be maintained, and weekly reports of anticipated capital position were required as well.

For its part, Freddie Mac has announced its intention to register its common stock voluntarily with the SEC, but has set no specific target date for accomplishing this goal. It is expected that when it does, it will file the periodic financial disclosures required under the Securities Exchange Act of 1934, and otherwise duplicate Fannie Mae's voluntary reporting and registration. Moreover OFHEO has indicated it intends to ensure that such requirements and implementing rules and regulations remain applicable to both Freddie and Fannie, whether Freddie registers with the SEC or not, and whether either, or both, "de-register" at some point. In addition, there remains significant Congressional interest in strengthening OFHEO, and/or moving the regulatory authority from HUD to the Treasury Department, in recognition of both the essential nature of Freddie Mac and Fannie Mae as institutions, and the significant impact their size, soundness, and operations have on the nation's financial services sector in general.

2. Freddie Mac's Operations

Like its larger "cousin," Freddie Mac does not lend money directly to consumers; that remains the province of the lenders. Freddie Mac's specific underwriting and program standards do circumscribe the mortgages that it will buy, and hence, the mortgages that lenders can sell to it. This is said to increase the amount of loans that produce "investment quality mortgages," which, in turn, should lower interest rates. In effect, these standards are supposed to reduce incrementally the amount that might otherwise need to be charged for default risk to compensate for losses on those loans that should not have been made in the first instance. Some of the other byproducts of Freddie Mac's business operations in the secondary market are more readily discernable, even if not presently amenable to an objective measurement of their beneficial impact.

In fact, one of those byproducts consists of a system developed by Freddie Mac labeled the Loan Prospector®, which it describes as an automated underwriting service. Touted as a "re-engineering of the loan origination process," Loan Prospector® factors in mortgage eligibility alternatives to traditional underwriting guidelines otherwise followed by Freddie Mac, thereby increasing the pool of potential borrowers, and again lowering the cost of loan origination for lenders. It is also said to assist lenders in obtaining the information needed to make consistent, fair, and reliable lending decisions. This product developed out of Freddie's position as one of the "800 pound gorillas" in the secondary mortgage market. Freddie Mac's relationships, and constant interactions with lenders, mortgage insurers, software vendors, and other key industry players, gave it a unique perspective on the process by which the loans it purchased were produced. More significantly for the purposes of this paper, its role as ultimate guarantor of enormous sums of money tied up in those loans gave it a considerable incentive to develop a product that made it both easier, and cheaper, to produce more quality loans.

A chief difference between Freddie Mac and Fannie Mae is often said to lie in the business strategies employed to achieve their missions, which are the same, as are their charters, congressional mandates, and regulatory structures. While difficult to quantify, one distinction that has been pointed out on more than one occasion is the fact that Freddie Mac appeared to engage in more complex hedging strategies in an effort to manage earnings than did Fannie Mae. Indeed, over the past several years there have been periods of time when Freddie Mac, though smaller in size, appeared to perform better than Fannie Mae in OFHEO risk-based capital and stress test studies done of the portfolios of each of these mammoth GSEs. However, as noted elsewhere, the complexity of the strategies pursued by Freddie Mac may well have contributed to the difficulty in producing timely and accurate reports of results for the year 2003, and to the anticipated delay in reporting official results for 2004 operations as well.

C. Analysis of the Benefits Provided by Fannie Mae and Freddie Mac

According to a report from the Office of Management and Budget (OMB), mortgage rates are 25–50 basis points lower because Fannie Mae and Freddie Mac exist in the form and size that they do. At the higher end of this range, borrowers nationwide are calculated to save an average of nearly $23.5 billion annually. A 1996 report prepared by the Congressional Budget Office (CBO) analyzed the activities of Freddie Mac and Fannie Mae, with an eye toward quantifying the benefits to consumers and the funding and other advantages enjoyed by Freddie and Fannie. Its results appeared to find a less significant benefit from the operations of these GSEs, and also seemed to suggest that they enjoyed outsized advantages due to their GSE status.

In a separate analysis of that study commissioned by Freddie Mac, and conducted by James C. Miller III, a former director of the OMB, and James E. Pearce, the authors concluded that the CBO study both understated the consumer benefits, and overstated the so-called "funding advantage" enjoyed by Freddie and Fannie. By their own estimates, Freddie Mac and Fannie Mae generated interest cost savings for American consumers of between $8.4 billion and $23.5 billion per year. In contrast, the authors estimated the value of the "funding advantage" that Freddie and Fannie indirectly receive from federal sponsorship at between $2.3 billion and $7 billion annually. Moreover, the authors point out that the maintenance of liquidity in the mortgage market during periods of financial turbulence, and the expansion of home ownership opportunities for low income and minority families, cannot be quantified easily, and no attempt was made to try and do so.

The analysis by Miller and Pearce concluded that federal sponsorship of Freddie Mac and Fannie Mae provides a "second-best" structure for the housing finance system, after the assumed "first best" system of no government involvement whatsoever. Among other things, the authors cite the fact that Freddie Mac and Fannie Mae supply housing finance more efficiently than could the depositories acting alone. In fact, the report notes that banks and thrifts receive federal support in the form of deposit insurance, access to Federal Reserve Bank liquidity, and Federal Home Loan Mortgage advances, and that gives them an average cost of funds lower than Freddie Mac and Fannie Mae. The Miller-Pearce report goes on to identify additional benefits that derive from the presence, operations, and scope of these two giants of the secondary mortgage market.

The sheer enormity of the presence of Freddie Mac and Fannie Mae in the conventional loan market has the effect of reducing interest rates on all conforming mortgage loans, not just those purchased by either entity. In addition, Miller and Pearce argue that the two giants tend to have a beneficial, albeit indirect, effect on the jumbo loan market as well. In sum, they point out that Federal Home Loan Banks have sponsorship similar to Freddie Mac, and have access to cheaper funds from FHLB banks. Member banks, however, only put 20 percent of these cheaper funds into conventional, single family mortgages for low to moderate income borrowers, while Freddie Mac, with its higher cost of capital, directed 31 percent of its funding to such loans in 1990. The Miller-Pearce report suggests that over one-half of the funds advanced by the FHLB go to fund jumbo loans, which are made disproportionately to upper income buyers. Thus, the presence of Freddie (and Fannie) allows FHLB member banks to devote more of their own resources to jumbo loans, arguably at a cheaper cost than might otherwise be possible.

Additional benefits cited by the Miller-Pierce report include: the increases in underwriting efficiencies that have followed initiatives from Freddie and/or Fannie; increased information availability for consumers; standardization of the mortgage lending process; and, more objective qualifying criteria via automated underwriting processes, such as the Loan Prospector®. Moreover, the authors point to an increased availability of low down payment mortgages, a development that some critics actually consider somewhat dubious. Of course, compared to the availability of home equity lines in excess of 100 percent of the value of a home made possible by the private market, this may be a relatively mild defect. The report also references such difficult-to-quantify benefits

as the "dynamic efficiency and liquidity" during periods of capital market stress, citing the 1994 Orange County, California bankruptcy, and the defaults by Russia and various Southeast Asian countries in 1998–1999.

Finally, the Miller-Pearce report makes the point that any risk to taxpayers theoretically posed by Fannie Mae and Freddie Mac would transfer to other federal programs if the duo's funding and other advantages were stripped away in an effort to reduce risk. For example, assuming a decrease in the capacity to make conventional loans, due to a decrease in the secondary market for same, the demand for FHA and VA loans, which are explicitly guaranteed and/or insured, would increase. In addition, faced with theoretically higher interest rates for mortgage loans, borrowers would increase the use of the somewhat more risky adjustable rate mortgages (ARM), again increasing the stress on the government-backed portion of the mortgage market.

The analysis prepared by James Miller and James Pearce was probably commissioned by Freddie Mac. Still, it appears to be a scholarly and objective analysis of the benefits accruing from the existence and operation of the secondary mortgage market makers known as Freddie Mac and Fannie Mae. For the full text of the report, go to http://www.freddiemac.com/news/analysis/gse_benefits2.htm.

D. Sallie Mae

The Student Loan Marketing Association is a GSE whose primary purpose is to provide federally guaranteed student loans originated under the Federal Family Education Loan Program (FFELP). Sallie Mae has assets of $52.9 billion, and ranks among the 60 largest United States corporations based on assets. It currently owns or manages student loans for more than 7 million borrowers, employing nearly 8,000 individuals at offices nationwide. Its average managed portfolio of student loans exceeds $72 billion, including both federal and private loans. Sallie Mae's ownership of federally insured student loans represents approximately one-third of all such loans outstanding.

Loans made under the FFELP are backed by designated state or national nonprofit guaranty associations that provide loan insurance to lenders or holders of those loans. After a student applies for a loan, a guarantor approves the loan, provides the federal guaranty, and directs the lender to proceed with loan disbursement. The loan proceeds are then dispersed by the lender or loan servicer, and sent to either the school or the borrower. After graduation, repayment begins and the lender collects monthly payments, billing the government quarterly for special allowance payments. In the event payments are not made and default aversion does not work, a loan is declared in default after 270 days of delinquency. Then, the guaranty agency purchases the loan and files for partial reimbursement from the Department of Education. Loan servicers then work to locate and collect the defaulted loan for the benefit of American taxpayers. Sallie Mae assists the guarantors in managing their loan programs with administrative and technical support, and provides a centralized point of contact for operational, technical, contractual, and policy issues.

Sallie Mae began its operations in May 1973. It spent the first phase of its existence as a GSE providing a successful secondary market for student loans. In 1984, the first non-voting common stock in Sallie Mae was listed on the New York Stock Exchange, under the symbol SLM. After 23 years of operation as a GSE, in 1996 Congress passed legislation directing Sallie Mae to take steps to fully privatize. In 1997, the shareholders approved a privatization plan designed to end the company's GSE status and become a fully private corporation by 2006.

A proxy fight in 1997, led by Sallie Mae CEO Albert L. Lord, installed new management promising growth through increased diversification of the company's offerings. At that point, the GSE became a subsidiary of SLM Holding Corporation. In the year 2000, the holding company purchased the assets of USA Group, temporarily changing its holding company name to USA Education Inc. In 2002, the holding company renamed itself to realign with its market identity, Sallie Mae. Sallie Mae completed privatization at the end of 2004 and terminated all of its ties to the federal government.

Since it began the privatization process in recent years, Sallie Mae has diversified into other areas, such as default aversion and collections, and has placed a new emphasis on retail operations. In a very real sense, it has undertaken its own vertical integration, so that Sallie Mae is now present in virtually every phase of the financial aid process, from helping families plan how to pay for higher education, to collecting on defaulted student loans. Recently, Sallie Mae announced an offer to repurchase the remaining outstanding debt from the GSE, leading to the completion of full privatization one year earlier than predicted, and three years before the deadline set by Congress in the 1996 legislation.

The FFELP was authorized by Congress as part of the Higher Education Act of 1965. Since 1966, more than 116 million loans have been issued under the FFELP, representing over $343 billion in federal student loans. About 71 percent of all student loans, approximately $28 billion annually, is provided under this program. In 1991, student loans cost taxpayers 8.5 cents for every loan dollar outstanding. By the year 2000, that cost had dropped to 0.8 cents. Although it is not clear that any empirical study has been done to determine the causes that may be behind this reduction, it is evident that Sallie Mae and its supporters believe that it has played a significant role in that decline.

E. Farmer Mac

Established as a GSE in 1988, the Federal Agricultural Mortgage Corporation purchases mortgages securing farmland, and securitizes them for sale to investors. Currently, Farmer Mac enjoys many of the same funding advantages enjoyed by Freddie Mac and Fannie Mae. However, Farmer Mac has come under scrutiny by Wall Street and private sector competitors due to rapid growth in recent years. In a recent GAO report, Farmer Mac was criticized for its "investment strategy, particularly its off-balance-sheet investments and its purchase of assets not directly related to its mission."

A proposed Farm Credit Administration rule would soon force Farmer Mac to seek a formal credit rating. The implications of this rule are manifold. Most noticeably, the rule would make borrowing money more expensive for Farmer Mac. Currently, Farmer Mac does not determine the risk of the securities it purchases. Consequently, all purchases are weighted equally in terms of their risk. Thus, Farmer Mac is able to then set aside the minimum of capital, 20 percent, to secure each purchase. A credit rating would change this practice, and 20 percent risk-weighting would only be possible for securities rated AA or better. The introduction of risk-weighting could potentially change Farmer Mac' s investment strategy. According to Farmer Mac, such a change could affect, in turn, the ability of its consumers to buy its debt.

The proposed rule, if adopted, would not become fully effective for 18 months. The comment period expired in October 2004, and a final rule is anticipated in early 2005. Although Farmer Mac is not necessarily known for the type of lobbying success story associated with Freddie Mac and Fannie Mae over the years, it does have a constituency that is easily mobilized during election years. Therefore, it remains to be seen whether this proposed reform survives to be implemented as written.

F. Ginnie Mae: A Non-GSE Agency

The Government National Mortgage Association is a wholly owned corporate instrumentality of the United States, within the Department of Housing and Urban Development. It traces its origins to the 1934 National Housing Act, which created Fannie Mae, but it did not become Ginnie Mae until 1968, when the functions of the former Fannie Mae were effectively split into two entities: one public, and one a GSE. Its mission is similar to that of Fannie Mae, as it seeks to expand and stabilize the supply of mortgage capital for residential home buyers.

As described by Ginnie Mae, the housing finance market was inefficient and illiquid in its early days, with mortgage rates varying considerably from region to region, while some areas had practically no mortgage

funds available at all. Not surprisingly, Ginnie Mae attributes this to the fact that it was virtually impossible to sell individual mortgages in a secondary market. Accordingly, Ginnie Mae "stepped into the breach" to solve this problem in 1970, by pioneering the issuance of mortgage-backed securities (MBS) through a guaranty mechanism for investors. In fact, MBS guaranteed by Ginnie Mae are the only mortgage-backed securities to carry the full faith and credit guaranty of the United States Government.

Unlike its GSE counterparts, Ginnie Mae does not buy or sell loans, nor does it issue any MBS itself. As such, it does not use derivatives to hedge, nor does it carry long-term debt. What it does is guarantee investors the timely payment of principal and interest on MBS that are, in turn, backed by federally insured or guaranteed loans. Mainly, these loans are insured by the FHA or guaranteed by the VA. However, loans eligible for a Ginnie Mae MBS guaranty include these from programs sponsored by the Rural Housing Service division of the Department of Agriculture, and HUD's office of Public and Indian Housing. With a Ginnie Mae guaranty in place, and underlying assets consisting of government-backed loans on real property, mortgage lenders can obtain a better price for their loans in the secondary market, freeing up more capital than might otherwise be available when they are sold.

Ginnie Mae MBS are created when eligible mortgage loans are pooled by approved issuers and securitized. Investors receive a *pro rata* share of the resulting cash flows, net of servicing and guaranty fees.

The MBS are of two types. One is characterized by the fact that the underlying mortgage loans must all be of the same type and from the same issuer, with a minimum size of $1 million. A separate MBS allows multiple issuer mortgage pools, with a minimum pool size of $250,000 for multi-lender pools and $1 million for single-lender pools. Ginnie Mae also offers real estate mortgage investment conduits, which are direct principal and interest payments from underlying MBS, with different principal balances, interest rates, average lives, prepayment characteristics, and final maturities. This allows issuers to create securities with short, intermediate, and long-term maturities.

II. Catastrophe Risk Transfer Mechanisms

A. Traditional Risk Transfer Mechanisms

The familiar methods for risk transfer of catastrophic exposures include standard property and casualty insurance. Individuals and businesses pay a designated premium to insurers, who have calculated the level of premium required, based upon various existing models that rely upon past results and statistics to predict anticipated losses in a given category of exposure. Ideally, the sum collected is sufficient to provide insurers with sufficient capital to pay the losses that occur, and provide a reasonable return, so that solvency is assured and shareholders and other investors continue to support the ongoing operations of the insurers. In addition, the premium should be at a level that does not encourage adverse selection, but instead, leads to a risk profile with a wide enough base to make it more likely that actual experience will be in line with the models used. The difficulties that terrorism risk present for this traditional model are dealt with in great detail elsewhere, and will not be discussed further here.

The second "layer" of risk transfer in the insurance industry occurs when insurers—so-called cedants, or ceding insurers—transfer some of the risk they have taken on via individual policies, to reinsurers, who take it upon themselves for a portion of the premium collected. In general, reinsurers are not underwriting individual risks, but classes of business—*e.g.*, commercial auto property damage coverage in the Northeast United States, windstorm exposure for residential property on the Gulf Coast, or non-California domestic products-completed operations liability risks from a specific ceding insurer. Moreover, for the most part, they are more

focused on the class of business and the operations of the cedant than on individual risk characteristics of particular policyholders. There are additional levels of ceding that may occur, and the relationship between the policyholder and initial cedant-insurer can take several different forms. Included among these are situations where the cedant is engaged primarily in bringing in the policyholder's business and administering claims. Notably, such a posture is somewhat analogous to the commercial lender who originates a mortgage, sells it to the secondary market, and merely services the loan afterwards.

The ability to transfer a portion of the risk to a reinsurer allows ceding companies to diversify their risk portfolio and reduce certain exposures. At the same time, it is intended to free up the ceding company's balance sheet, in effect, and allow it to write more business. As noted above, it also allows ceding companies to focus more of their operations on areas other than the raising of capital and management of surplus, albeit within the framework of the extensive regulatory regime present in each of the fifty states. In some ways, then, reinsurance serves a function similar to that of the secondary market for mortgage loans, although there is no "securitization," as such, of the underlying asset. The reinsurance sector also has had difficulty in analyzing and pricing terrorism risk, and has, for the most part, decided it is not interested in providing capacity for this risk.

B. Government-Sponsored Catastrophic Risk Insurance Programs

There are various government-sponsored insurance programs in the United States, including those designed to respond to catastrophe risks, as well as those designed to insure against financial and credit risks. The reader is commended to review the excellent summary of various programs contained in the statement of Thomas J. McCool, Managing Director, Financial Markets and Community Investment for the Government Accounting Office, in his October 24, 2001, testimony before the Senate Committee on Banking, Housing and Urban Affairs, given in the aftermath of the tragic events of September 11, 2001. For the full transcript, see the Committee's website, http://www.senate.gov/~banking/_files/107805.pdf. His initial remarks are noteworthy, and presumably still illustrative of the predominant view on the ideal role of the federal government in this area:

Any mechanism established by the federal government to support the ability of individuals and businesses to get insurance for terrorist acts should address several significant concerns. Most important, the program should not displace the private market. Rather, it should create an environment in which the private market can displace the government program. Second, it should be temporary, at least initially. Finally any program should be designed to ensure that private market incentives for prudent and efficient behavior are not replaced by an attitude that says, "Don't worry about it, the government is paying."

The remarks of Director McCool go on to discuss certain features of selected insurance programs covering catastrophic or terrorist events, both domestically and internationally.

Here is a summary of some of the government-sponsored catastrophic risk insurance programs.

1. Insurance for Catastrophic Nuclear Accidents

Salient features of this program include: mandatory participation, limitation of private sector liabilities, and "implicit" government backing. No nuclear accidents have occurred since the legislation was enacted that cost more than was provided by available private insurance, so the program has never really been called upon to respond.

2. Insurance Against Risks Inherent in Overseas Investments

The Overseas Private Investment Corporation (OPIC) operates this program, which is geared to domestic companies with investments in physical plant, equipment, and/or other approved projects in certain desig-

nated developing countries. Features include voluntary participation, with the federal government acting as the insurer and risk bearer. Over the life of OPIC, the government has made money on the insurance provided.

3. Insurance Against Urban Riots and Civil Disorder

Features of this program include: voluntary participation, encouragement of states and the private sector to provide insurance in urban areas, and federal reinsurance for insured property in urban areas. The reinsurance feature, designed to last five years, made money because claims never reached anticipated levels. Program premiums were shifted to the subsidization of crime insurance programs, and discontinued entirely in 1984, due to the lack of participation.

4. Insurance Against Floods

Features of the National Flood Insurance Program include: voluntary participation that is largely mandatory for property owners with federally guaranteed or insured mortgages in flood zones, federal government as the insurer for flood risk in communities that join the program, and subsidization of rates to encourage mitigation efforts. The program is not actuarially sound by design, and Congress has had to appropriate funds for the program from time to time. Further, the Federal Insurance Administration has periodically had to borrow on its U.S. Treasury credit line of $1 billion to finance operating losses in certain years of significant flooding.

The Flood Insurance Program has a Mitigation Division, whose focus is to reduce the costs of disaster assistance needed for uninsured losses, through better flood plain management, improved building codes, and more widespread purchase of flood insurance. The Mitigation Division estimates that every $3 paid in flood insurance claims saves $1 in disaster assistance payments.

5. California's Insurance Against Earthquakes

Features of the program, which was established in the aftermath of the 1994 Northridge earthquake, include: participation in the Earthquake Authority based upon statutory requirements, funding by assessments on insurance companies, and no public funding. By 2001, approximately seven years after the Northridge quake, the Earthquake Authority provided virtually all of the earthquake insurance available in the state of California.

6. Florida Hurricane Insurance

The recent spate of hurricanes in Florida and the Gulf Coast highlighted the existence of the state-sponsored Florida Hurricane Catastrophe Fund (FHCF), established in the wake of the devastation from the 1992 Hurricane Andrew. The FHCF acts as a state-administered reinsurance program, and is mandatory for residential property insurers writing wind or hurricane coverage on structures located in Florida, and includes contents and living expense coverages. The private sector remains the primary risk bearer below a $4.5 billion retention level, with the state fund available for 90 percent of larger losses, up to a cap.

According to the Florida Office of Insurance Regulation, the cost of coverage through the FHCF runs from one-fourth to one-third the cost in the private market, contributing to lower premiums, the stabilization of the market, and a reduction in the need to tap the residual market. As part of the bargain with the industry resulting in the FHCF, Florida insurers were given permission to drop approximately 90,000 policyholders in high risk areas. These are insured through a separate state-sponsored insurer of last resort. In a further effort to limit their exposure, property insurers have increased their deductibles to a percentage of insured value, and many have set up separate Florida affiliates in order to protect the surplus of the non-Florida business generated by the insurers.

The FHCF, which had capacity of $11 billion in 2003, is financed from three sources: reimbursement premiums charged to participating insurers, investment earnings, and emergency assessments on Florida property and casualty insurers. Recent legislation had increased the authorized capacity to $15 billion, and allowed full "recharging" of the fund following a major hurricane, such as those that hit in rapid succession in 2004.

C. Catastrophe Bonds

In recent years, a new financial tool has been introduced for transferring the risks associated with catastrophic storms and other natural disasters. This new type of debt instrument, dubbed the catastrophe bond (CAT bond), has begun to gain traction in the capital markets. Basically, the bonds are floated for specific risks over limited periods of time in defined geographic regions. They are used primarily by insurers and reinsurers to reduce the risk otherwise faced on their insurance contracts by transferring it to investors in the capital markets. The investors who put their money into these instruments get a higher rate of return than might be available on other similar quality debt. In return for this higher return, they do face a risk of losing much, if not all, of their principal or interest, or both.

While CAT bonds are similar to ordinary corporate or government bonds in many ways, they have significant differences. For instance, return of principal on a CAT bond is contingent on whether the triggering catastrophic event occurs in the region, and during the time window, or is otherwise of the severity identified in the terms of the bond. If the "triggering" event does not occur, then principal is repaid just as in the normal bond. If the triggering event occurs, however, repayment of principal is partly or totally forgiven, and the insurer issuing the bond may use the bond proceeds to pay claims, as needed.

As with traditional bonds, the CAT bond is suitable for issuance by insureds as well. This has happened in more recent years, albeit in very limited instances. For instance, Tokyo Disneyland and Universal Studios Taiwan, each of whom have considerable earthquake risk exposure, have issued securities directly to the capital markets. In addition, similar to corporate and government bonds, CAT bonds sold in the U.S. must be distributed by registered broker dealers, and the larger investment banks tend to place most of them. As this type of security has become more frequent and more profitable, reinsurers themselves have begun forming their own broker-dealers to participate in the market.

Most CAT bonds are tied to either a loss index (for example, total insured losses from an earthquake in California) or to a disaster severity index (for instance the Richter scale measurement at a specific location in Japan), rather than to the issuing insurer's specific losses. CAT bonds do trade, although there may not be much activity unless and until, for instance, a hurricane develops that may hit landfall in an area covered by a specific CAT bond. At such time, the price of the bonds will come down substantially, but once (or if) the threatened hurricane passes, the prices of the bonds should recover substantially all of their losses.

Commentators frequently point to the $477 million CAT bond issuance by automobile insurer United Services Automobile Association in 1997 as one of the first significant, successful uses of this vehicle for transferring CAT risks. This bond was designed to protect the insurer against catastrophic losses from hurricanes in Florida. One recent example came in a June 16, 2004, announcement by Converium, the Swiss-based reinsurer spun off by Zurich Financial Services in 2001. It announced $100 million in floating rate notes with a five-year maturity, placed with private investors and priced at the London Interbank Offered Rate (LIBOR), plus 40 basis points. The bond contingency is triggered by second and subsequent perils from Atlantic hurricanes, United States and Japanese earthquakes, and European windstorms.

The basic process behind a CAT bond starts when the sponsor, or the issuer of the bond, establishes a special-purpose reinsurer to issue them, and to provide a source of reinsurance protection. The issuer sells the bonds to investors, and the proceeds are invested in a collateral account. The collateral is generally a very safe

security, such as a Treasury bond. The sponsor of the bond pays a premium to the issuer. Essentially, the cash flow generated by the collateral and this premium is used to pay interest to the investors during the term of the bond. If a qualifying event triggers the bond, funds are withdrawn from the collateral account and paid to the sponsor, who uses the funds to pay the claims as they are finalized. At maturity, any remaining principal is paid to investors. If a triggering event has not occurred, of course, 100 percent of the principal is repaid to the investors.

Generally speaking, CAT bonds pay a fixed spread over the prevailing LIBOR. This spread might be described as roughly comparable to a premium paid for the insured event that underlies the bond. These bonds tend to be "short tail" in nature, although the maturity cycle has drifted upwards over time, ranging from as little as six months to more average time frames of 36 months. Generally speaking, hurricane bonds will have a shorter duration than earthquake bonds, for obvious reasons. The maturity of bonds issued is also somewhat affected by the reinsurance cycle, with longer maturity bonds tending to be issued when the bond premiums and reinsurance rates are at the lower end of the reinsurance cycle. When higher premiums prevail, the tendency will be to issue shorter maturity bonds.

One of the crucial reasons why insurance-linked securities such as CAT bonds have become of interest to insurers and to Wall Street alike is the fact that the capacity of the capital markets is so much larger than that of the insurance and reinsurance markets alone. Recent events, like the series of substantial hurricanes in Florida in the summer of 2004, raise the specter of a catastrophic accumulation of losses that the property casualty insurance market could not absorb alone. In fact, one of the chief reasons that such instruments are attractive to capital markets is that they are essentially uncorrelated with any other markets in which investors maintain a significant position. Regardless of how any of the other more traditional investments in a given portfolio may perform, there is generally going to be very little correlation between those investments and the "return" on a CAT bond tied to earthquakes in excess of 6.2 on the Richter scale in Kobe, for instance. As such, CAT bonds serve as a valuable, though typically very small, part of a diversified portfolio.

Another advantage of a CAT bond is its better overall credit risk profile. In other words, the risk that the entity that is required to pay on the bond may not pay is virtually zero. This is because a special-purpose reinsurer has been set up, which then places the proceeds of the bond sale into a trust, funded with very safe securities, that exists only for the purpose of this single transaction. However, an investor in a CAT bond may still face the same type of moral hazard risk that exists in a normal insurance scenario. For instance, the insurer issuing the CAT bond may write too much insurance in regions protected by the securities, on the theory that it can increase its collection of premiums but not its overall risk, because that will be funded by the bond proceeds. In addition, there is a risk that the insurer will over-report claims, so that it draws down unjustified amounts of the funds held as collateral. As such, CAT bonds tend to have a co-insurance feature, so that the insurer only collects funds equivalent to a certain percentage of the losses after a triggering event occurs, and still shares some of the risk with investors.

Moody's Investors Service has reported that CAT bond issuances were running at four-to-six per year, in the sum of approximately $1 billion, in the years leading up to 2003. Moody's reports that the figures for 2003 increased to $1.5 billion over 13 transactions. Even though CAT bonds form a relatively small portion of the insurance risk securitization market, analysts have believed for several years that there is a significant prospect for the growth of this particular segment of the industry. Moreover, it is still generally limited to risks in major industrial powers. It has, however, been discussed as a potential source for funding CAT risks in developing countries as well. International reconstruction agencies, like the World Bank and the International Monetary Fund, have expressed interest in using such a tool from the private capital markets in conjunction with their own resources for addressing such risks.

In principle, the CAT bond vehicle would appear to be well suited for the type of catastrophe risk profile presented by terrorism events as well. However, the volume, in both dollar terms and number of transactions, is still very small. The type of public/private cooperative model perhaps envisioned by the IMF and World Bank for coping with traditional CAT risks may have some use in the planning for a post-TRIA environment. As CAT bonds make use of the global capital markets successfully tapped by GSEs such as Freddie Mac and Fannie Mae, it may be a vehicle ideally suited for the role a GSE might play in the event the federal government is not going to be a guarantor of terrorism risk losses after 2005.

D. Other Risk Transfer Mechanisms

It has been reported that the CAT bond idea has been migrating to other weather-related risks, auto lease residual values, space launch exposures, aviation risks, life insurance, oil platform risks, and possibly to environmental risks as well. Moreover, there has been discussion of the usefulness of such a capital market tool to cover more traditional liability risks, including certain products liability exposures. There have even been efforts to transfer the idea to a pure financial risk by, for instance, issuing reverse convertible debt instruments. In this approach, debt holders are able to convert their bonds into stock if the issuing company fails to meet certain specified financial benchmark objectives.

There are several other ways in which the market has provided an opportunity to "securitize" catastrophe risk. One example includes what is referred to as a "call spread" traded on the Chicago Board of Trade. These contracts pay off when losses exceed a certain retention level, or "lower strike," and continue to pay until reaching a cap, called an "upper strike." While similar in structure to excess of loss reinsurance, they do not pay off based on the loss experience of a specific insurer, but rather, are based on industry wide loss indices.

Another example of an insurance-linked security is the catastrophic equity put option. In essence, this provides an insurer with contingent equity financing. The issuer would have the right to issue a pre-specified amount of equity, usually in the form of preferred stock at a specified price, contingent on the occurrence of the specific triggering catastrophic event. Thus, an option is written and sold to the company by investors, who receive an option premium from the issuer, typically an insurer. If the triggering event occurs—in this scenario, an earthquake, hurricane or other catastrophe—it may cause losses severe enough to depress the stock price of the issuer. If it is depressed below the level in the catastrophic equity put option, the insurer will then issue shares at the pre-specified price, giving it the capital infusion it needs. On the other side of the equation, it gives the option holder a stake in what was presumably already an attractive company that is now positioned to "weather the storm" of its CAT exposure.

III. Subrogation and Terrorism Losses

The debate over the availability of terrorism risk insurance capacity—whether with a government backstop or without—at times appears to presuppose no meaningful opportunity for either insurers or the federal government to recover any loss payments they might make from parties actually responsible for causing the losses. This is understandable, particularly if the events of September 11, 2001 is a paradigm: foreign, non-state actors, with no obvious "corporate" or commercial ties, who do not survive the attack that results in the loss. Such a view, however, may need to be modified as the litigation arising out of the September 11th attack moves forward.

There are already serious efforts to seek recovery from sovereign states, charitable organizations alleged to be funders and/or facilitators of the September 11th terrorists, and miscellaneous private businesses and/or individuals alleged to have assisted the terrorists in some way. Included among the groups pursing such efforts are insurance companies seeking to enforce subrogation rights in an effort to recover payments made to policy-

holders on account of terrorism losses. In the event that a government-sponsored enterprise is formed to step into the role the federal government now occupies under TRIA, it will likely be in the position of a large—if not the ultimate—subrogee with respect to a catastrophic terror loss. As such, it would be particularly important for any such entity to monitor the developments in the September 11th litigation, including taking advantage of available *amicus curiae* opportunities, even if it has no direct stake in any recovery for this pre-existing loss.

A. General Principles of Subrogation

One of the best descriptions of the concept of subrogation is found in a holding in a California court decision, *Patent Scaffolding Co. v. William Simpson Construction Co.*, 256 Cal.App.2d 506, 509, 64 Cal.Rptr. 187, 190 (1967), which contained an enumeration of the elements of a cause of action for equitable subrogation. Although frequently associated with inter-insurer claims, rather than claims by an insurer against a third-party wrongdoer, the principles of equitable subrogation are essentially equivalent to the traditional subrogation principles found in the latter scenario. In *Patent Scaffolding*, the California court held that a claim for equitable subrogation is stated under the following circumstances (emphasis added):

> (1) The insured has suffered a loss for which *the party to be charged is* liable, either because the latter is *a wrongdoer whose act or omission caused the loss* or because he is legally responsible to the insured for the loss caused by the wrongdoer; (2) the insurer, in whole or in part, has compensated the insured for the same loss for which the party to be charged is liable; (3) the insured has an existing, assignable cause of action against the party to be charged, which action the insured could have asserted for his own benefit had he not been compensated for his loss by the insurer; (4) the insurer has suffered damages caused by the act or omission upon which the liability of the party to be charged depends; (5) justice requires that the loss should be entirely shifted from the insurer to the party to be charged, whose equitable position is inferior to that of the insurer; and (6) the insurer's damages are in a stated sum, usually the amount paid to its insured, assuming the payment was not voluntary and was reasonable.

Generally, subrogation rights are not that significant in connection with efforts to ameliorate or reduce losses paid by a property insurer after a typical mass catastrophe, such as a hurricane or an earthquake. A review of the above formulation reveals why fairly quickly. In general, there is no single or sufficiently monolithic "party to be charged" who could be said to be responsible for causing the loss in any direct sense. Obviously, since storms and earthquakes are natural events, there is simply no one to whom the average property insurer has recourse for the substantial bulk of any losses paid. It may be true that, in isolated instances there may be a third party against whom some subrogation rights might exist for acts or omissions that arguably made the loss sustained worse than it would or should have been, absent the third party's contributing fault.

A typical example of this last situation would involve a builder who constructed the property sustaining a loss. Assume such building was allegedly built to specifications sufficient to withstand either a Category 3 hurricane in Florida or a 6.5 earthquake on the Richter scale in California. The insurer would argue that a complete collapse and total loss of that newly built structure in the face of a Category 1 hurricane or an earthquake measuring 5.1 on the Richter scale was, to some degree, the fault of the builder. Thus, the insurer, theoretically, would be entitled to recover at least some of the money it paid to the insured for a total loss of the property in question. Such a situation would represent by far the exception rather than the rule for insured property losses, however, and could not be counted upon as a significant source of subrogation recovery for a property insurer in a catastrophe. For all practical purposes, the insurer can neither prevent the catastrophe, nor shift the blame for the loss caused by the catastrophe to a deep pocket to any significant degree.

Subrogation, as such, is also not a significant factor in losses that become the subject of civil actions against parties who have purchased liability insurance of one form or another. In such actions, the person or entity that has sustained injury or damage bring suits against a party whom the injured party feels is partially or completely responsible, legally or otherwise, for causing the loss. It is not uncommon for the defendant chosen by the plaintiff to believe, correctly or not, that one or more other parties are actually responsible for the loss sustained by the plaintiff, again, either in whole or in part. Typically, the defendant in such a civil suit, generally at the direction of, or acting in concert with his liability insurer, will expand the civil action to include those other parties. In effect, then, the determination of liability and how, if at all, it will be allocated amongst the "parties to be charged," is determined within the suit brought by the original plaintiff.

Most often, the original defendant's third-party action against other allegedly responsible parties proceeds by way of indemnity, contribution, statutory provisions, or other theories. Moreover, the original defendant insurer is not required to pay the plaintiff for any losses sustained until that liability is determined. As such, the defendant's insurer is not technically entitled to "subrogation," which requires that it first make payment to its insureds. As a practical matter then, whatever "subrogation" rights the original defendant's liability insurer might have had are determined within the context of the civil litigation, whose endpoint becomes the payment of some money by the various insurers to the injured party.

B. Terrorism Losses and Subrogation

The situation that exists after a terrorism loss presents a difference scenario than either of the examples discussed in the preceding section. As with the typical catastrophe loss, there is an immediate need to pay the insured victims of the terrorism event for their losses, be it losses of real or personal property, business income, life, or medical expenses associated with the injuries sustained by those who survive the event. Insurers will not generally find it possible to promptly pursue responsible third parties, and certainly not prior to the need to make payments to the insured policyholder victims. However, unlike in the typical catastrophe loss rising out of a natural disaster, there may well be one, or a relative handful, of large, responsible "parties to be charged" with the ultimate responsibility for causing the catastrophic loss. As such, subrogation opportunities likely will exist, even in a situation like the September 11th attack: foreign, non-state actors, with no obvious "corporate" or commercial ties, who do not survive the attack that results in the loss.

In fact, there is presently a multidistrict litigation proceeding pending in the United States District Court for the Southern District of New York, before Judge Richard C. Casey, entitled *In re Terrorist Attack on September 11, 2001*, Civil Action No. 03-md-1570. Included among the cases within the coordinated proceedings is one filed by several dozen insurance carriers, including members of the Chubb, Zurich, and CNA groups, such major homeowners' insurers as Allstate, as well as United Kingdom issuers, including members of a premier Lloyd's syndicate. The carriers are seeking to recover as subrogees to their various commercial insureds under policies providing coverage for loss of property, business interruption expense, and/or workers compensation benefits. The first amended complaint filed in that action states derivative claims for: trespass; wrongful death; survival actions; assault and battery; intentional and/or negligent infliction of emotional distress; recovery under the Torture Victim Protection Act, Pub.L. 102-256, 28 U.S.C. §1350; conspiracy; civil RICO (18 U.S.C. §1962(a)); aiding and abetting; violation of 18 U.S.C. §2333 via an act of international terrorism; negligence; and punitive damages.

The subrogation action enumerates payments to policyholders of approximately $3.5 billion, and requests a recovery of $4.5 billion for property damage, business interruption losses, workers compensation benefits payments, and other damages under the trespass count. It also seeks, *inter alia*, $50 million for each assignor under the Torture Victim Protection Act, and treble damages under the RICO counts of $13.5 billion for the property damage, business interruption losses, and workers compensation benefits, and another $150

million for each assignor of individual personal injury claims. In addition, it seeks a separate award of punitive damages of $300 million for each assignor, and in excess of $60 billion for the property damage, business interruption losses and workers compensation benefit payments made.

Some, or perhaps all, of the existing litigation efforts may come to naught. However, it is reasonably likely that some will achieve at least a modicum of success in the form of obtaining judgments in United States courts against individuals and/or entities and/or states, with collection of said judgments much less likely. Among other difficulties likely to be encountered are problems of personal jurisdiction, internationally recognized service of process, sovereign immunity, enforcement of judgments obtained in one country in another country where assets may be located, identification of the proper parties/entities/political subdivisions to be named as defendants, state department or other federal government foreign policy and/or diplomatic prerogatives, including attendant regulatory or injunctive proscriptions on collecting the judgments obtained, the interplay of U.S. and international civil versus criminal prosecutorial regimes, issues arising from the sheer expense of the efforts, and additional similar considerations.

The *In re Terrorist Attack on September 11, 2001* MDL proceeding referred to above has already encountered many of the procedural problems attendant to such an undertaking. Motions to dismiss for failure to effect proper service, claims of sovereign immunity, lack of minimum contacts, lack of subject matter jurisdiction, diplomatic immunity, and failure to state a claim have already been filed. Many are still pending decisions at the trial level, much less appellate review. An example of one setback in this effort is found in a ruling in an action filed in August 2002, by the Ness, Motley firm, on behalf of more than 6,000 plaintiffs. That case was transferred to the MDL proceeding subsequent to the December 2003 consolidation order. The judge who handled the matter prior to transfer ruled that two members of the Saudi royal family were immune from damage claims under the law excluding acts of foreign officials from the jurisdiction of United States courts. Collection efforts have not yet become a problem, in the MDL of course, but certainly will be in the future, even if judgments are ultimately obtained.

A recent decision by a federal appellate court serves to illustrate difficulties those seeking to recover for losses arising out of terrorist activity may encounter. In *Hegna v. The Islamic Republic of Iran*, 376 F.3d 226 (4th Cir. 2004), the Hegna family members were judgment-creditors of Iran; their claim stemmed from the death of Charles Hegna in a 1984 hijacking of a Kuwaiti Airlines flight at the hands of Hezbollah, a recognized terrorist organization with ties to Iran. Although unable to proceed against Iran for many years due to the Foreign Sovereign Immunities Act, 28 U.S.C. §1604, a 1996 amendment thereto under the Antiterrorism and Effective Death Penalty Act eliminated this roadblock. Under AEDPA, victims of terrorism were permitted to sue countries designated as state sponsors of terrorism, like Iran, if they provided "material support" for terrorist acts. See 28 U.S.C. §1605(a)(7).

The Hegnas filed suit against Iran and its agent, the Iranian Ministry of Information and Security, in April 2000, and obtained a default judgment, following the failure of the defendants to appear, in February 2002. The Hegnas then attempted to enforce their judgment by obtaining writs of attachment in aid of execution on two Iranian-owned properties in Bethesda, Maryland. Due to the severance of relations between the United States and Iran, those properties were in the possession of the U.S. Government. The United States moved to quash the writs, on the ground that the properties were not "blocked assets," as defined by the Terrorism Risk Insurance Act of 2002, and were therefore not subject to attachment. The district court agreed, and quashed the writs.

The Court of Appeals for the Fourth Circuit affirmed, albeit on different grounds. That court found it unnecessary to decide whether the properties constituted "blocked assets" under TRIA, so that issue remains open. Instead, it found that the Hegnas had relinquished all rights to attach the properties in satisfaction of

their judgment by accepting compensation under the Victims of Trafficking and Violence Protection Act of 2000, Pub.L. 106-386, §2002 (Victims Protection Act). Among other things, the *Hegna* decision demonstrates the difficulty of successfully navigating the complex web of statutory provisions and exceptions relevant to pursuit of sovereign states that assist terrorists. Moreover, it is a reminder of the similarly complex interrelationship of U.S. laws and regulations relating to terrorist activity, and such traditional state law provisions as those governing attachments in aid of execution upon a judgment.

Recent regulatory activity illustrates a somewhat more prosaic example of the difficulties a subrogated insurer may face in pursuit of recoveries. The U.S. Department of Homeland Security recently approved various anti-terrorist products of four companies under the Support Antiterrorism by Fostering Effective Technologies Act of 2002 (SAFETA), thereby protecting these companies from product liability suits related to such products. Essentially, the manufacturers will now be able to avail themselves of the "government contractor defense," which shields companies from liability for products which are made to government specifications. It also prohibits joint and several liability for non-economic damages relating to certified anti-terrorist technology, bars punitive damages and prejudgment interest, and limits a maker's liability to a specified amount of liability insurance coverage for each product.

The products now enjoying these protections include: a threat analysis system developed by Lockheed Martin of Maryland; a bomb detection system made by Michael Stapleton Associates of New York; a biohazard detection system produced by Los Angeles-based Northrop Grumman; and a water jet cutting system designed by Teledyne Brown Engineering Inc., of Huntsville, Alabama. Of course, any claims against these producers that might test the limits of such protections have yet to arise. Moreover, they would be in the nature of the claims against the builder who failed to build an insured structure to specifications, as referenced above, rather than the claims against an aider or abettor of terrorism advanced in the subrogation action pending in the September 11th MDL referenced above. Nonetheless, each type of claim would have the same goal—reduction of the net insurer payout on losses sustained by policyholders—and each would face legal obstacles to the achievement of such goals.

It should be noted that the deadline for filing claims against such non-terrorist defendants as the airlines and airport security systems involved in the September 11th events did not pass without those parties being made the subject of suits now joined in the MDL, including suits brought by insurers. Significant restrictions exist in connection with such claims as well, because of post-September 11th legislation, and bankruptcy proceedings involving some of the defendants. Whether such claims are pursued as vigorously as those against the parties accused of funding or otherwise assisting the terrorists themselves remains to be seen, as does the ultimate recovery that subrogated insurers can expect to see from either class of defendants.

IV. Developments Potentially Affecting Recovery of Terrorism Losses

Despite the difficulties pointed out above, there have been developments in the legal and other arenas that may point toward a more realistic possibility of obtaining some recoveries against parties responsible in some measure for terrorism-induced losses. Not all of these developments are directly related to either the September 11th events, or to specific pursuit of subrogation for terrorist losses by insurers. Nonetheless, they all touch upon issues that whomever is tasked with bearing responsibility for payment of insured terrorism losses in the post-TRIA environment must keep in mind. This is particularly so if all aspects of loss mitigation and potential future avoidance of such events through propagation of disincentives to aiders and abettors of terrorism are to be explored fully.

A. Monitoring Osama bin Laden, al-Qaeda, and the Taliban

On January 17, 2003, the United Nations Security Council adopted Resolution 1455, which was designed to improve the implementation of measures included under prior Security Council resolutions passed in 1999, 2000, and 2002. The earlier resolutions were directed against Osama bin Laden, al-Qaeda, the Taliban, their associates, and associated entities. Those measures included a freeze of financial and economic assets, a travel ban, and an arms embargo, and were to be applied by all countries against the individuals and entities designated by a special committee, the al-Qaeda and Taliban Sanctions Committee. In addition, a monitoring group of experts appointed under the resolutions are to monitor and report on the implementation of the measures by states, and to follow up on leads where there appears to be incomplete implementation. The monitoring group submitted two extensive reports during 2003, and has assessed the 83 reports submitted by individual states pursuant to the same resolution.

According to the most recent report, there has been significant progress in blocking funding to al-Qaeda, at least in terms of existing funds that have been located and frozen. Further, the report notes that the international financial community is devoting a significantly increased amount of resources to the effort. However, al-Qaeda apparently continues to receive funding from charities, deep pocketed individual donors, and through miscellaneous business and criminal activities, inclusive of the drug trade. Moreover, members of the network seem to continue to bypass the major organs of the international financial community through the use of alternative remittance systems. In addition, the network has shifted much of its financial activities to areas in Africa, the Middle East, and Southeast Asia that lack either the resources and/or the willingness to closely regulate such activity. As such, it seems that a point of diminishing returns is being reached.

The report of the monitoring group points out the difficulty of controlling the charities that are suspected of funneling funds to al-Qaeda and associated networks to support terrorism. In fact, as many of these charities devote their primary activities to religious, educational, social, and humanitarian programs, there is great reluctance to disrupt such activities. In particular, the monitoring group points to the International Islamic Relief Organization as an example of a charity that it reports is principally involved in such beneficial activities, but which also has been used to assist in financing al-Qaeda in some respects through some of its constituent organizations. A separate problem is that some charities, even when they have been placed on a designated list, have not been shut down by certain member states. Moreover, many of the charities implicated in the funding of al-Qaeda are also engaged in separate business ventures to supplement their income.

The report of the monitoring group concludes that there must be tougher and more comprehensive resolutions obligating states to take the mandated measures if the United Nations role in combating al-Qaeda and related terrorist organizations is to keep from being marginalized. The report also concludes that the obligation to block assets should expand beyond bank accounts and other intangible financial assets. Specifically, the monitoring group believes that it should include business or property owned or controlled by the designated individuals and entities. In any event, establishing an effective liaison with the monitoring group might be a useful thing to include on the list of action items for any post-TRIA regime. If nothing else, the monitoring group may prove a valuable link to the international efforts directed to locating property suitable for attachment, and "piercing the veil" of dubious front organizations for international terrorist groups.

B. The "Golden Chain Charities" Investigations

The United States Customs Service has undertaken an investigation of a cluster of interlocking charities and businesses in Northern Virginia. The Customs Service, which in the wake of the September 11th attacks has become the Bureau of Immigration and Customs Enforcement under the Department of Homeland Security, has joined forces with the Internal Revenue Service and the FBI in this investigation. What they found was a maze

of corporations and nonprofits, many of which have been named in suits that are now part of the September 11 MDL proceedings, along with various individuals associated with one or more of the groups or businesses.

The international network that the Justice Department is trying to unravel has three basic groups. The first is a collection of Muslim political organizers and businessmen in the United States. Much of their funding comes from the second group, rich Saudi Arabian businessmen, some of whose names are on a purported list of Osama bin Laden supporters known as the "Golden Chain." The apparent links between these two groups are alleged to be the top leaders of the Muslim Brotherhood in Europe and the Persian Gulf.

Not unexpectedly, some of the financial institutions identified in the investigation have not only denied involvement, but have retaliated against news organizations that have published stories to that effect by filing libel suits. Moreover, many of the wealthy individuals cited have conceded contributing to numerous charities, but denied knowledge that any had ties to terrorist activities. In addition, a common defense to an accusation that one's name appears on the Golden Chain list is that the listing dates back to the individual's support of groups fighting the Soviet occupation of Afghanistan, at a time when the American government was prominently on the same side in that fight.

Unraveling the truth behind these assertions will be an important part of the existing efforts to establish liability in the MDL proceedings. Fortunately for the insurers and others pursuing such claims, they will have the benefit of being able to rely, to some extent, upon the findings of the U.S. agencies engaged in these parallel efforts.

C. The MDL Proceedings

As noted above, the spate of lawsuits filed by direct victims of the September 11th attacks, both corporate and individual, as well as by insurers pursuing subrogation claims, have mostly been transferred to the multi-district litigation proceedings pending before Judge Casey in the federal Southern District of New York. With dozens of parties, and high-powered lawyers on all sides, it is expected that it will be quite some time before definitive results can be claimed by either side, and the subsidiary and procedural issues at play are themselves labyrinthian in their detail. Those charged with crafting, or operating in, the post-TRIA terrorism risk transfer environment would do well to follow the progress of the *In re Terrorist Attack on September 11, 2001* MDL proceedings.

D. The September 11th Victims Fund

The September 11th Victim Compensation Fund has achieved a significant level of success, at least as measured by the participation level. Some 97 percent of potential September 11-related death claims settled without litigation against the World Trade Center owners, the Port Authority of New York and New Jersey, and United and American Airlines. For an in-depth analysis of the creation and operation of this fund, see Professor Gilliam Hadfield's White Paper, beginning on page ___ of this volume. Whatever its flaws, the remarkable rate of participation is testament to the fact that such funds can have their place in any governmental response to truly catastrophic terrorism events. As any major defendant in a class action settlement can attest, the other side of that equation—the results of the claims pursued by the 3 percent of claimants who "opted out"—may be the final determinant of whether the Fund was a success for all stakeholders.

E. Settlements with Government of Libya

Remarkable developments involving state-sponsored terrorist actions have occurred in the nation of Libya, accused in two of the most notorious terrorism events of the 1980s. Absent a complete breakdown and/or an improbable full reversal of recent numerous public, multilateral actions and pronouncements, Libya will

have undergone a dramatic transformation in its attitude toward cooperation with the world community. The 2004 disclosures regarding the Libyan nuclear weapons program, and that nation's agreement to cooperate with United Nations nuclear inspectors, are probably the most significant of the developments concerning Libya. However, the apparent settlement of the 1988 Lockerbie bombing and the 1986 Berlin disco bombing may be of more direct interest.

On December 21, 1988, Pan Am Flight 103 exploded over Lockerbie, Scotland, killing all 259 on board, along with 11 people on the ground. Eventually, in November of 1991, the United States and British governments indicted Libyans Abdel Baset Ali Mohmed Al-Megrahi and Al Amin Khalifa Fhima, thought to be Libyan intelligence agents, with 270 counts of murder and associated crimes. The United Nations imposed sanctions on air travel and arms sales to Libya in April of 1992, in response to Libya's refusal to turn over the suspects for trial in Scotland. Libya considered a proposal to transfer the suspects to a neutral panel made up of international judges, but was rebuffed by the U.S. and Britain, who wanted the trial to take place in a U.S. or British court.

In December 1998, a federal appeals court ruled that relatives of the 189 Americans killed in the Pan Am bombing could sue Libya for its possible role as sponsor of the attack. See *Rein v. Socialist People's Libyan Arab Jamahiriya*, 162 F.3d 748 (2d Cir. 1998). At approximately the same time, the Libyan People's Congress, with the apparent blessing of Muammar Gaddafi, agreed to a trial of the Lockerbie suspects in the Netherlands, under Scottish law. The suspects were transferred to the United Nations the following April, and then transported to the Netherlands for trial. At the same time, the U.N. suspended air travel and arms sale restrictions against Libya. Existing U.S. sanctions, in place since the early 1980s, were untouched, but in June of 1999, American and Libyan representatives met to discuss the lifting of those sanctions for the first time in 18 years.

Trial of the Lockerbie suspects began on May 3, 2000, and finally resulted, on January 31, 2001, in a guilty verdict against Al-Megrahi, and a not guilty verdict in favor of Fhima. In the wake of the guilty verdict, attorneys representing relatives of the American victims began negotiations with Libyan lawyers claiming to be acting on behalf of "concerned businessmen," but actually proceeding with full authority from Tripoli. By May of 2002, Libya offered up to $10 million for each of the 270 victims, or $2.7 billion, with the actual payout dependent upon the lifting of United Nations and United States sanctions. A framework for dispensing the settlement was reached almost one year later, in April of 2003. It called for an initial payment of $4 million per victim if U.N. sanctions were lifted, followed by another $4 million if U.S. sanctions were lifted, and a final $2 million if Libya was removed from the U.S. State Department's list of state sponsors of terrorism.

The role of the private American lawyers in this entire process is noteworthy. Even though they did not possess authority to make promises on behalf of the United States, their negotiation of the framework for the civil settlement helped set the terms of the debates that followed, in both the United States and the international diplomatic communities.

Subsequently, on September 13, 2003, the United Nations Security Council voted 13–0, with 2 abstentions (the United States and France, citing Libya's record of involvement in terrorism, particularly its pursuit of weapons of mass destruction, and continuing concerns over human rights, respectively), to lift the sanctions. In January of the following year, Libya threatened to withhold compensation payments because of the U.S. failure to lift economic sanctions, setting a deadline of May 12, 2004 for resumption of trade. In April, the United States partially lifted the sanctions, allowing most commercial business, investment, and trade, as well as travel, but keeping Libyan assets in the U.S. frozen. Moreover, Libya was not removed from the State Department's list, and in view of the recent evidence linking the Gaddafi government with a plot to assassinate Saudi Crown Prince Abdullah, it is unclear if that particular item has been thrown into doubt.

The May 12 deadline was extended twice, with a final extension to September 22, 2004. Reports are to the effect that 80 percent of the Lockerbie families sent a letter to President Bush urging that the U.S. drop the

remaining sanctions, unfreeze Libyan assets, and remove them from the State Department list. On September 20, 2004, President Bush signed an executive order removing the remaining U.S. commercial sanctions. This step, effective September 21, the deadline eve for the second of the three scheduled payments to the victims' families, declares Libya in compliance with the removal of WMD, but does not remove Libya from the list of state sponsors of terrorism. A recent report on the State Department's website indicates that U.S.-Libya relations are generally improving. See http://www.state.gov/r/pa/ei/bgn/5425.htm#relations.

In what can probably be viewed as a related development, on September 3, 2004, Reuters announced that Libya formally signed an agreement to pay $35 million in compensation for more than 160 victims of the 1986 bombing of a Berlin nightclub. The settlement was signed by the head of Muammar Gaddafi's charity foundation and German lawyers representing the victims, and followed a 2001 German court ruling that the Libyan secret service was behind the bombing. United States victims were not covered by this agreement. Taken together with the Lockerbie settlement, it is clear we have witnessed an extraordinary, albeit excruciatingly slow, change in belligerent Libyan behavior toward the international community.

The reasons behind Libya's dramatic change are certainly open to debate. Moreover, there is good reason to take seriously the concerns of those who decry the settlements as mere payment of "blood money," with no assurances that past behavior has truly been punished, or that future bad behavior will be deterred. Nonetheless, in the absence of a fully functioning international criminal justice system, or efficient, effective, and timely United Nations checks on truly state-sponsored international terrorism-related activities, it is more, at least, than we could have expected as recently as six years ago. What it portends, if anything, for the future of bringing state-sponsored terrorism to heel in a post-TRIA environment also remains to be seen. It is, however, a development in the right direction.

F. Prosecution of Suspects in the U.S.S. Cole Bombing

Evidence suggests that the international community is substantially engaged in the legal battle to bring terrorists to justice, even among some whose stance toward terrorists has been questioned in the past. For example, according to an AP wire story reported by CNN.com, on July 7, 2004, a Yemeni court charged six Yemenis in planning the October 2000 bombing of the U.S.S. Cole, alleging that they belonged to Osama bin Laden's terrorist network. The United States initially resisted an early trial so Yemen could investigate the crime more thoroughly, and thus, make convictions more likely.

One of the six, Abd al-Rahim al-Rashiri, is actually in U.S. custody at an undisclosed location, after having been detained by the United Arab Emirates in November 2002. The other six appeared in court in Yemen to answer charges, and were awaiting the appointment of lawyers. Al-Rashiri is believed to have helped direct the 1998 bombing of U.S. embassies in Kenya and Tanzania in which Osama bin Laden is believed to have had a hand. Recently, CNN reported that the Yemeni court sentenced Al Rashiri and one other defendant to death for their roles in the bombing. The court also sentenced the other four to prison terms ranging from five to ten years for their participation in the attack. All are expected to appeal their sentences.

Yemen is bin Laden's ancestral homeland and a hotbed of al-Qaeda sympathizers. Accused of tolerating Muslim extremists for a long time, it has cracked down since September 11th, and even allowed U.S. forces to train Yemeni troops to fight terrorists. Whether this cooperation will extend to taking steps to make those who aid and abet terrorism financially responsible, or indeed, whether it may extend to any steps that might assist in preventing future terrorist attacks, is an open question.

G. Civil Suits by Victims of Terrorist Bombings

Victims of the September 11, 2001 attack are not the only ones instituting suits in United States courts against aiders and abettors of terrorism. In *Linde, et al. v. Arab Bank, et al.*, filed in federal court in New York, families of U.S. citizens killed or hurt in terrorist attacks in Israel have filed suit against Arab Bank. The bank is accused of channeling money to Palestinian terrorist groups, and making insurance payments to beneficiaries of suicide bombers. The suit further claimed that the Jordan-based bank's New York branch has laundered Saudi aid to terrorists.

H. Applying the Alien Tort Claims Act

In *Sosa v. Alvarez-Machain*, 124 S.Ct. 2739 (2004), the United States Supreme Court upheld the Alien Tort Claims Act, but limited its reach. This 18th century statute had been used with some success by human rights groups to bring cases in the United States against aliens who committed torture in other countries when victims subsequently moved to the United States. At least one international tort expert, William Casto, whose work was cited by Justice Souter in his opinion for the Court, and by Justice Scalia in his concurrence, suggested that the decision was influenced, in part, by the war on terrorism. In effect, he suggests that the Court wanted to leave open the possibility of lawsuits under the ATCA, preferring to let Congress further define or delimit such actions as it considers possible additional actions in the ongoing war on terror.

In brief, Justice Souter agreed that the ATCA was intended to be a jurisdictional statute, but also argued that it allowed torts in violation of international law that would have been recognized at the time it was enacted in 1789. The three examples he cited were violation of safe conducts, infringement of the rights of ambassadors, and piracy. In his concurrence however, Justice Scalia disagreed with Justice Souter's description of the door to such suits being "ajar," saying that it remains for another case to decide whether the Court will even open the door.

The *Sosa* case had been filed on behalf of the Mexican doctor who had brought a claim stemming from his 1992 kidnapping from Mexico to the United States, where he was arrested and tried for the murder of a federal drug agent (he was later acquitted). The lawyer who argued the case on the doctor's behalf seemed to feel that the results in the case would not prevent the types of claims that have been accepted since 1980 under the ATCA from continuing to be successful. These claims included torture, genocide, disappearances, summary executions, war crimes, and crimes against humanity. The scope of "aiding and abetting" as a tort principle was left undecided by *Sosa v. Alvarez-Machain*, however, according to both sides of the debate over whether that case is a help or hindrance to those seeking to use ATCA affirmatively.

One of the primary areas of concern for domestic corporations and critics of the law in general is the potential for the *Sosa* decision to be applied to United States corporations for, *e.g.*, complicity in alleged human rights abuses occurring with government involvement in countries where the U.S. corporations do business. However, its more germane use is in pursuit of foreign government officials or members of the military who either retire here, or are in the U.S. on a transitory basis, perhaps most famously in the case against the estate of Ferdinand Marcos. Similar opportunities may arise for use of ATCA in the war on terror. Moreover, it would seem that U.S. branches of foreign charities, found to be agents or instrumentalities of foreign states and accused of money laundering or other support for Al Qaeda, have much to be concerned about if *Sosa* is held to leave the door "ajar" to such suits.

I. International Cooperation in Sharing Information About Terrorism

In *Intel Corp. v. Advanced Micro Devices, Inc.*, 542 U.S. 241 (2004), the United States Supreme Court ruled that a United States judge had the power to require an American corporation to turn over its records to

foreign regulators. In essence, the Court upheld a federal statute as providing sufficient authority for American judges to use their discretion to help people or governments obtain testimony or information for use in foreign or international tribunals, such as overseas criminal prosecutions. The ruling came in a case that arose out of an effort by a smaller competitor of Intel Corporation that wanted to use Intel documents before the European Commission, a regulatory board charged with enforcement of European Union antitrust laws.

The Commission had been investigating whether Intel improperly used its dominance of the chip industry to keep other companies from winning market share in Europe. Somewhat paradoxically, the Commission apparently took the position that a U.S. court should not be involved in what was essentially a European regulatory matter. In any case, Justice Ginsburg made clear that the rule *allowed*, but did not require, a federal district court to provide judicial assistance to foreign or international tribunals, or to "interested persons," in proceedings abroad. The Supreme Court did limit the holding, preventing it from being used to get privileged material.

At first glance, the decision in *Intel v. Advanced Micro Devices* appears to have nothing to do with either terrorism or any connection to the Terrorism Risk Insurance Act of 2002. However, it confirms that the door is open for a U.S. court to assist a foreign tribunal or governmental body investigating terrorist activities or financial ties in an area not currently being pursued by the U.S. Thus, it is potentially another arrow in the quiver of those who would seek to pursue subrogation recoveries after payment of a terrorism-related loss.

J. Actions Against Banks Assisting Possible Terrorists

The United States Treasury Department recently announced sanctions against two foreign banks, which were cut off from the U.S. financial system because of suspected money laundering. One, Infobank of Belarus, was accused of helping Saddam Hussein skim funds from the United Nations oil-for-food program in Iraq. Indeed, the report of chief U.S. weapons inspector Charles Deulfer concerning the scope and extent of Iraqi programs related to acquisition of weapons of mass destruction suggests that many private and governmental actors, including among some traditional U.S. allies, had a hand in helping Iraq evade the U.N. weapons embargo as well. Also designated by the Treasury Department was First Merchant Bank of the Turkish Republic of Northern Cyprus. It and Infobank were designated as "primary money laundering concerns" under the U.S. Patriot Act. The fact that the Treasury Department feels it has enough evidence to make such designations under the Patriot Act suggests that there may be an investigative trail worth pursuing against these banks.

Undoubtedly, we have yet to see the full scope of proceedings that may be initiated against Saddam Hussein or dictators like him, who have ruled countries accused of being state sponsors of terrorism. As discussed, below, foreign banks are not the only financial institutions accused of hiding money in the name of former dictators accused of human rights violations, both inside and outside of their home countries. One would think that the United States banking community would be very interested in making sure that such foreign institutions receive at least as much scrutiny as U.S. institutions that accept deposits from foreign leaders accused of hiding assets.

K. Continuing Implications of the Pinochet Case for International Fund Transfers

The decision issued a few years ago by Great Britain's highest judicial authority in the case involving Chilean leader Augusto Pinochet was a landmark in the law of sovereign immunity, although it had no direct or immediate impact on the former general at the time. Recent decisions by the Chilean Supreme Court and other Chilean authorities, judicial and otherwise, suggest that he has, however, finally lost his immunity from prosecution in connection with the deaths of political opponents in the 1970s. The consequences of that development are also now being felt by various banking institutions that have done business with Pinochet over the years.

In connection with various investigations of Pinochet's past activities, millions of dollars in his funds have been discovered in United States banks. The investigators, in looking into irregularities at a prominent Washington, D.C. bank, found $4 million to $8 million in secret Pinochet accounts. This money had apparently improperly and surreptitiously been transferred from the London office of the bank in an effort to evade attachment by the British government while he was under house arrest in London in 1999. Over several years, the bank continued to participate with Pinochet in manipulating various accounts and trusts, keeping his identity a secret from U.S. examiners seeking to determine whether anti-money laundering statutes were being violated.

The same bank implicated in the Pinochet affair has been fined $25 million for other lapses in its compliance with the anti-money laundering rules, in connection with accounts held by the embassies of Saudi Arabia and oil-rich Equatorial Guinea. In February 2005, Chile's second largest bank agreed to demands from U.S. regulators that it stop doing business with both Pinochet and his attorney. In addition, the bank agreed to stop concealing information from U.S. and international regulators, and to correct practices in its New York and Miami offices that violated anti-money laundering laws. Apparently, the Chilean bank had facilitated many transfers of Pinochet funds from the Washington bank in question. Judicial authorities in Chile and Spain are also seeking information concerning banking business with Pinochet from these banks, as well as from other banks in the U.S., Switzerland, Spain, and Luxembourg.

The significance of the legal and regulatory action against Augusto Pinochet lies in the possibility that, with diligent pursuit, investigators and prosecutors may eventually require even heads of state and other prominent leaders of state-sponsored terrorism to answer—at least financially—for the consequences of their actions.

L. Pursuing International Funding of Terrorist Activities

In the West African nation of Sierra Leone, the United Nations has established a "Special Court," whose mandate includes pursuit of individuals who bear the greatest responsibility for war crimes, crimes against humanity, and violations of international humanitarian law committed in Sierra Leone from 1991 to 2002. This hybrid war crimes tribunal is scheduled to exist for three years only, after which time its mandate, and presumably, its funding as well, will expire.

David M. Crane, the chief prosecutor to the Special Court, has opined that the general cause of the conflict in Sierra Leone and its environs was control over diamonds. Crane believes that the rebels responsible for much of the carnage were controlled by outside international actors. These outsiders virtually enslaved combatants, and terrorized populations in parts of West Africa, where they were forced to mine diamonds in virtual captivity. The passage of the Clean Diamond Trade Act in the United States implements the obligations otherwise spelled out under the Kimberley Process.

The Special Court's connection to international terrorism may not be immediately evident. However, there are suggestions that Al Qaeda and its associates have moved their financing activities from more familiar international channels to such comparatively less regulated areas as Africa, the Middle East, and South Asia. As the chief prosecutor to the Special Court has pointed out, the root cause of much of the bloodshed in Sierra Leone is economic—control of the vast wealth associated with the diamond trade, with such control exercised by outside actors. This could be part of the Al Qaeda effort to increase and diversify its sources of funding to carry out spectacular acts of international terrorism, and for that reason should be closely watched. The Special Court for Sierra Leone is one source of expertise and evidence that might be relevant in determining if future terrorist acts that produce large insured losses might be linked to funding fueled by trade in so-called "conflict diamonds."

M. International Complexities

In 2004, a court in the Persian Gulf state of Qatar convicted two Russian intelligence officers of setting off a car bomb that killed the former leader of Chechnya's separatist movement. The court concluded that the assassination, which occurred in the Qatari capital of Doha, was ordered by Russian leaders in Moscow. The Russian government has denied any involvement, though it had, in the past, accused the victim of having terrorist ties. In fact, the victim had been placed on a United Nations list of suspected terrorists tied to the al-Qaeda network at Russia's urging.

United States authorities provided technical assistance to the investigators on the case, and were involved in the collection of some of the evidence. In a sense, the U.S. was on both sides of the case, as the Russian defense team included former U.S. Attorney General Richard Thornburgh. While direct implications for TRIA and post-TRIA subrogation efforts are lacking, the Qatar assassination case is nonetheless worthy of note: the U.S. role illustrates the complexity of international legal and diplomatic entanglements, and how support for the process of international criminal law can end up placing American interests at odds with its partners in the war on terror. The case also suggests the premium placed on proceeding through formal legal channels when seeking to achieve results in foreign jurisdictions.

V. Conclusion

For the moment, it appears that the private sector not only welcomes, but fervently desires, federal government involvement in the insurance of terrorism risks. In fact, absent the "make available" provisions of the Terrorism Risk Insurance Act of 2002, it is no great stretch to say that the insurance industry at large would be quite content to forego the premium for this risk, and simply exclude it entirely. It is possible that this attitude will change with the development of a mature, functioning, and profitable private sector market for transferring the risk of terrorism-inflicted losses from the public at large to the insurance industry, or perhaps, as touched upon above, to capital markets generally.

However, for the time being, virtually all stakeholders weighing in on the topic seem to indicate that the private sector is not prepared to assume the full burden of terrorism risk transfer upon the currently scheduled expiration of TRIA at the end of 2005. Thus, if there is to be any continuing obligation to fund losses associated with the type of catastrophic terrorism event the nation witnessed on September 11, 2001, some vehicle for transforming this inability to respond in a fiscally responsible manner must be found.

While certainly a unique type of loss in many ways, it is not unfair to suggest that terrorism losses are somewhat comparable in degree and kind to what is referred to as catastrophe (CAT) losses. Accordingly, as further context for the consideration of how a government-sponsored enterprise might fit into the scheme of any post-TRIA environment, those charged with determining the post-TRIA regime may wish to consider some of the ways in which CAT risks have been transferred in more traditional areas, such as hurricane and earthquake losses.

As the above discussion of certain GSEs (and one government-backed analogue in the mortgage sector) discloses, the form and nature of a GSE can change over time, and transformation to a purely private entity is not out of the question. This last point is worth remembering in the context of the consideration of a role for a GSE in any post-TRIA regime. Moreover, although each of the GSEs discussed above are concerned primarily with the creation, expansion, and/or maintenance of secondary markets for traditional debt instruments (*i.e.*, mortgages or student loans), there is no inherent reason why the concept cannot be employed in a different part of the financial services sector. In addition, while risk transfer has traditionally been thought of as the province of the insurance industry, as the discussion of CAT risk transfer above notes, there is a growing trend

to look to the much larger capital markets for this type of risk transfer. That is precisely the environment in which these GSEs now operate.

The experience of GSEs with a stake in reducing the risks faced in accumulating and/or guaranteeing the debt instruments they purchase has tended to produce creative solutions to some of the inefficiencies existing in the markets they serve. In the post-TRIA context, perhaps GSE involvement could similarly lead to minimum standards for security measures at high risk property locations insured against terrorism losses. Moreover, the myriad and complex set of issues surrounding the potential for subrogation recoveries against aiders and abettors of terrorism suggest a problem for which a large, powerful, and closely regulated entity with ties to the federal government may be a possible solution. Whether a GSE is a short term, intermediate term, or long term response to the capacity deficit in catastrophic terrorism risk transfer, or even a bridge to any solution at all, is a subject that may deserve the attention of those deciding what will follow TRIA.

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