

Risk analysis

Presidents and risk precedents

The probability of a hung US presidential election now falls into the category of an uninsurable risk, argues David Rowe

As Peter Bernstein points out on **page XX** of this issue, insurance companies allow their customers to transform damaging consequences into manageable consequence by applying what he calls the one free lunch in economics: diversification.

The effectiveness of diversification varies considerably, however, in mitigating different kinds of risks. Premature death is the classic example of an insurable risk. Any one person's death is the ultimate binary event. It happens or it doesn't. In contrast, the mortality rate of any reasonably large population with known characteristics is highly predictable. In the case of disaster insurance, such as property and casualty or flood policies, diversification is valuable but less effective than in the case of life insurance. In these latter cases, the volatility of losses remains considerable even when spread across a significant number of instances. Such insurance works by providing sufficient capital to absorb occasional spikes in losses.

Some disasters, however, have such huge and widespread consequences that no sufficient source of capital is available to compensate for the associated losses. Significant political instability in the world's most powerful nation surely qualifies as such an uninsurable contingency. I have little time for the Jeremiads of professional alarmists. Nevertheless, as I write this in early December there is still uncertainty about who will serve as the next US president. Even when that issue is decided there will be concern, and an associated risk premium, related to a possible repetition of this extended uncertainty. As Bernstein points out: "Volatility in the economic (and I would add political) fundamentals intensifies our overall sense of risk and increases the premium we require for entering into deals of any kind."

How did it happen?

As *The New York Times* put it: like weak knees to a professional athlete, close elections are the most vulnerable point of a democratic system of government. Since political instability insurance to compensate for consequent losses is unrealistic in this situation, the only available source of risk mitigation is to minimise the probability of an uncertain outcome no matter how close the election. The obvious approach along these lines would be to institute a clearer and less error-prone method of voting. Why has this not been done in the US before now? The perennial temptation to avoid the immediate cost for insuring against highly unlikely events played a part.

Just as important, however, US voting proce-



David Rowe is president of the Infinity business unit at SunGard Trading & Risk Systems
e-mail: david.rowe@risk.sungard.com

dures are generally determined at the local county level. One county's improved voting procedures can do little to mitigate the risk of a close national election. Furthermore, local governments confront agonising trade-offs between the level of tax rates and the quality of municipal services, especially public schools. Faced with this, it is hardly surprising that many areas have opted to make do with 20- to 30-year-old voting technology. Votes are still being counted using punch cards that I last employed in my professional life in 1979. (And even when I used such cards it was with machines that guaranteed every hole was punched cleanly. Hanging and dimpled chads were never present, since even one wrong punch could have disastrous consequences.)

The Electoral College

Many outside the US (and, indeed, many inside the US) have been puzzled by the role of the Electoral College. At a basic level, this institution represents a compromise concerning division of power between the large and small states. Each state has one electoral vote for each member of the House of Representatives, where representation is based on relative population. It also has one electoral vote for each seat in the US Senate where every state is equally represented.

It is this partially equal representation of all states, regardless of population, that makes the possibility of a popular vote-winner losing the electoral vote more likely than would otherwise

be the case. Most criticism of the Electoral College is directed at the two votes allocated equally to every state. Nevertheless, altering this method for allocating electoral votes among states, let alone totally abolishing the Electoral College in favour of a national popular vote system, is a remote possibility. The reason is that such a change would require a constitutional amendment approved by three-quarters of all the states. As few as 13 states can block such an initiative. It would be rather like trying to eliminate the veto power of the British House of Lords in 1911 without King George V being prepared to expand the peerage by ennobling large numbers of supporters of the measure if it failed to pass. Don't hold your breath waiting for this one!

The Electoral College also plays one very constructive role in mitigating the risk of close elections. Like any first-past-the-post system, it severely restricts the places where ballot disputes are worth pursuing. Usually only a very few districts, eg, the State of Florida in the current election, qualify. Imagine if every precinct in the US was fair game in the search for more votes to count or to disqualify. Such, however, would be the case in a very close election decided by popular vote.

Ballot reform

Clearly, some initiative to reduce the risk of political instability resulting from an excruciatingly close election is both socially and financially desirable. Equally clearly, to be enacted, such an initiative must be viewed as having a neutral impact across the major parties and across the states. To my eye, some type of ballot reform is the only promising possibility.

The obvious model is the process one goes through in placing transactions online. The entry screen normally prevents selection of clearly inconsistent choices, like voting for two candidates for president. It also flags possible but questionable inputs and asks for confirmation that this is your intention, such as failure to cast a vote for any candidate for president. Finally, it gives a chance to review the full details of your order and asks for final affirmative confirmation that these details are correct. Surely a similar system is both feasible and highly desirable in the voting booth.

The likely way to bring it about is a federal initiative to subsidise the purchase of voting devices that meet these standards by local election authorities. It would be an insurance premium against future political instability that is well worth the modest cost. It also would serve to minimise any risk premium associated with concern over a similar event occurring in the future. ■