CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

November 19, 2004

H.R. 4634
Terrorism Insurance Backstop Extension Act of 2004

As ordered reported by the House Committee on Financial Services on September 29, 2004

SUMMARY

H.R. 4634 would extend the Terrorism Risk Insurance Act (TRIA) through calendar year 2007 and would add group life insurance to the lines of coverage offered under TRIA. Enacted in 2002, TRIA requires insurance firms that sell commercial property and casualty insurance to offer clients insurance coverage for damages caused by terrorist attacks. Under the act, the government would help insurers cover losses in the event of a terrorist attack. Under current law, TRIA will expire at the end of calendar year 2005.

CBO cannot predict how much insured damage terrorists would cause in any specific year. Instead, our estimate of the cost of financial assistance provided under H.R. 4634 represents an expected value of payments from the program—a weighted average that reflects the probabilities of various outcomes from zero damages up to very large damages due to possible future terrorist attacks. The expected value can be thought of as the amount of an insurance premium that would be necessary to just offset the government's average annual loss from providing this insurance, although firms do not pay any premium for the assistance offered by TRIA.

On this basis, CBO estimates that enacting H.R. 4634 would increase direct spending by about $1.1 billion over the 2005-2009 period and by $1.3 billion over the next 10 years. Under TRIA, the Treasury Department would recoup some or all of the costs of providing financial assistance through surcharges; hence, over many years, CBO expects that an increase in spending for financial assistance would be nearly offset (on a cash basis) by a corresponding increase in governmental receipts (i.e., revenues). We assume, however, that the Secretary would not impose any surcharges until one year after federal assistance is provided and that those amounts would be collected over several years. Thus, CBO estimates that enacting H.R. 4634 would increase governmental receipts by about $70 million over the 2005-2009 period and by $480 million over the next 10 years.

H.R. 4634 would extend or expand several intergovernmental and private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA). CBO estimates that the aggregate costs of complying with those mandates would not exceed the annual thresholds established by UMRA ($60 million for intergovernmental mandates and $120 million for private-sector mandates in 2004, adjusted annually for inflation).

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 4634 is shown in the following table. The costs of this legislation fall within budget function 370 (commerce and housing credit).

	By Fiscal Year, in Millions of Dollars									
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
CHANGES IN DIRECT SPENDING										
Estimated Budget Authority	10	200	390	310	170	80	50	30	20	20
Estimated Outlays	10	200	390	310	170	80	50	30	20	20
CHANGES IN REVENUES										
Estimated Revenues	0	0	0	20	50	70	80	80	90	90

BASIS OF ESTIMATE

For this estimate, CBO assumes that H.R. 4634 will be enacted by the end of calendar year 2004. We estimate that enacting H.R. 4634 would increase direct spending by about $1.3 billion and would increase governmental revenues by $480 million over the 2005-2014 period. While this estimate reflects CBO's best judgment on the basis of available information, the cost of this federal program is a function of inherently unpredictable future terrorist attacks. As such, actual costs could vary greatly from the estimated amounts.

H.R. 4634 would extend the Terrorism Risk Insurance Act through calendar year 2007. TRIA will expire under current law on December 31, 2005. TRIA provides up to $100 billion in financial assistance to commercial property and casualty insurers for losses above certain thresholds due to certain types of future terrorist acts. Upon enactment, H.R. 4634 would add group life insurance to the lines of insurance that are included in this program.

Under TRIA, federal assistance is provided if the Secretary of the Treasury certifies that a terrorist attack has occurred in the United States or other specifically covered location. Generally, for a terrorist attack to be certified, it must have been committed by a foreign interest and cause insured damages of at least $5 million. Furthermore, property and casualty insurance policies may exclude losses due to events involving nuclear, biological, or chemical materials. Thus, insurance coverage may not be available to policyholders for terrorist attacks involving those materials. An insurer suffering losses as a result of an attack would first pay claims up to a deductible, calculated as a specified percentage of its aggregate property and casualty insurance premiums for the preceding calendar year. Those deductible amounts increase each year under TRIA and would continue to increase under H.R. 4634, reaching 20 percent of premiums by 2007.

Once insurers have met their individual deductibles for damage claims due to a terrorist attack, the federal government would pay 90 percent of claims above the deductible amount up to the $100 billion in total insured losses. Insurers would be responsible for the remaining 10 percent. The federal government would be required to make future surcharges on the insurance industry to recoup some of the costs of federal assistance and would have the discretion to impose surcharges sufficient to recover all federal payments.

Direct Spending

By extending financial assistance to commercial property and casualty insurers for future acts of terrorism against insured private property, enacting H.R. 4634 would expose the federal government to potentially huge liabilities for two more years (2006 and 2007). For any year, CBO has no basis for estimating the likelihood of terrorist attacks or the amount of insured damage they may cause. Instead, our estimate of the cost of this program reflects how much, on average, the government could be expected to pay to insurers.

In the following sections, we describe our method for estimating the expected-value cost of providing financial assistance under H.R. 4634 and explain how we convert that expected-value cost to annual estimates of spending.

Estimating the Expected Cost of Federal Assistance. For this estimate, CBO discussed the concepts involved in estimating insured losses with industry actuaries and reviewed the models used by firms to set premiums for the terrorism component of property and casualty insurance they offer. State insurance regulators generally require such premiums to be grounded in a widely accepted model of expected losses from covered events. After the terrorist attacks on September 11, 2001, the insurance industry began efforts to set premiums for insurance coverage for terrorist events using such models.

Although estimating losses associated with terrorist events is difficult because of the lack of meaningful historical data, the insurance industry has experience setting premiums for catastrophic events—namely, natural disasters. Setting premiums for hurricanes and earthquakes, for example, involves determining potential areas that could sustain damage, the value of the losses resulting from various types of events with different levels of severity, and the frequency of such events.

Similarly, estimating premiums for losses resulting from terrorist attacks involves judgments regarding potential targets and the frequency of such attacks. Because there is a limited history of terrorist attacks in the United States, many of the parameters needed by the insurance industry to set premiums are based on expert opinion regarding terrorist activities and capabilities rather than on historical data.

Estimating potential insured losses. Based on discussions with insurers and information provided by the insurance industry, CBO estimates that the expected or average annual loss subject to coverage under TRIA would be about $1.5 billion, including $100 million from the inclusion of group life insurance policies under TRIA. This estimate incorporates industry expectations of the probabilities of terrorist attacks, encompassing the possibility of ones that result in enormous loss of life and property damage as well as the likelihood that no such attacks would occur.

CBO's estimate assumes that, in most years, terrorist attacks would cost less than $1.5 billion. We expect that there is a significant probability— approaching 50 percent—that no terrorist attacks that would be covered by TRIA would occur in a given year. Clearly, since enactment of TRIA, no covered events have occurred; we do not know whether attacks have been planned or attempted but were prevented by law enforcement and other security measures. Although the risk of a terrorist attack with many lives lost and substantial property damage still remains, based on industry models, CBO assumes for this estimate that attacks similar in scale to losses sustained on September 11, 2001, in New York City (an estimated $20 billion) are likely to occur very rarely.[1]

Adjusting insured losses to determine federal payments. To determine federal payments under TRIA, CBO made two adjustments to the expected value of estimated insured losses from a future terrorist attack. First, because federal payments under TRIA would not apply to losses that exceed $100 billion per event, we excluded potential costs above that level. Second, we decreased estimated losses to account for the deductible that would be paid by affected insurers in the event of a covered attack. Individual insurers would pay such deductibles before the federal government would make any payments under TRIA, and the

1. Industry estimates of losses on September 11, 2001, range from $30 billion to $40 billion, including about $20 billion in losses in New York City that would have qualified for coverage under TRIA had the law been in effect on that date.

total deductible paid by individual insurers could range from zero to several billion dollars depending on the number of insurers affected by a particular event.

CBO estimates that the Secretary would need to charge almost $700 million in each of calendar years 2006 and 2007 to fully compensate the government for the average annual cost of having to help pay for losses due to terrorist attacks under H.R. 4634. In addition, in calendar year 2005, the bill would add coverage for group life insurance policies to the current TRIA program. We estimate that provision would cost about $50 million.

In total, CBO estimates that the expected cost to the government of enacting H.R. 4634 would be about $1.4 billion. Actual spending, however, would be spread out over many years and would be repaid, at least in part, by surcharges imposed on policyholders.

Timing of Federal Spending. To estimate federal spending for this program on a cash basis, CBO used information from insurance experts on historical rates of payment for property and casualty claims following catastrophic events. Based on such information, CBO estimates that additional outlays under H.R. 4634 would total about $1.3 billion over the 2005-2014 period and about $100 million after 2014. In general, following a catastrophic loss, it takes many years to complete insurance payments because of disputes over the value of covered losses by property and business owners. For this estimate, we assumed that financial assistance to property and casualty insurers would be paid over several years, with most of the spending occurring within the first five years.

Revenues

Under H.R. 4634, CBO estimates that the Secretary of the Treasury would impose surcharges on policyholders that would increase revenues by $480 million over the 2005-2014 period. Surcharges could continue for many years beyond 2014.

Surcharges. If a terrorist attack were to require the Treasury Secretary to provide financial assistance, the government would recoup some of that cost through surcharges paid by the insurance industry and purchasers of commercial property and casualty insurance. H.R. 4634 would require the Secretary to recoup federal assistance up to a fixed "retention amount" set in the bill, less the amount already paid by insurers through the insurer deductibles and the 10 percent share of losses over the deductibles assigned to insurance firms. Under TRIA, that retention amount is $15 billion in 2005. Under H.R. 4634, the retention amounts would be $17.5 billion in 2006 and $20 billion in 2007, plus a slight adjustment upward to account for the increased exposure from the addition of group life insurance. Under H.R. 4634 (as under current law), the Secretary of the Treasury also would have the option to recover any federal assistance above the retention amount up to the total amount of federal assistance provided.

Under TRIA, the recoupment of financial assistance would be recovered by assessing each insurer based on its portion of aggregate property and casualty or group life insurance premiums for the preceding calendar year. Surcharges would apply to insurance sold following a terrorist attack that necessitated federal assistance, and each company's surcharge would be limited to 3 percent of aggregate premiums. H.R. 4634 would direct the Secretary to impose surcharges for as long as is necessary to recover the required portion of financial assistance. Thus, the government could collect surcharges for many years depending on the amount of financial assistance. CBO estimates that surcharges would total $480 million over the next 10 years for a two-year extension of TRIA and the addition of group life insurance coverage under the program.

Timing. CBO expects that the Secretary probably would not recoup the entire cost of financial assistance during the 2005-2014 period. Based on information from the insurance industry on aggregate premiums collected in recent years, CBO estimates that the administrator would recoup no more than about $100 million a year. The bill would allow the Secretary to reduce annual charges considering the effect on taxpayers, the economy, or burdens on small and medium-sized businesses. Therefore, if annual losses were very high, we expect that the Secretary would limit annual collections by spreading them over many years. CBO assumes it would take the Secretary at least 10 years to recoup the costs of any financial assistance provided under H.R. 4634. Thus, we estimate that around half of the surcharge collections would occur after 2014.

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

H.R. 4634 would extend or expand several intergovernmental and private-sector mandates. However, CBO estimates that the aggregate costs of complying with those mandates would not exceed the annual thresholds established by UMRA ($60 million for intergovernmental mandates and $120 million for private-sector mandates in 2004, adjusted annually for inflation).

Extension and Expansion of Mandates

The bill would extend several mandates contained in the 2002 Terrorism Risk Insurance Act and expand two of those mandates to group life insurers. Those mandates would:

- Require that certain insurers offer terrorism insurance;
- Require that certain insurers and their policyholders repay the federal government for the cost of assistance (in the form of surcharges); and
- Preempt state laws regulating insurance.

Requirement to Offer Insurance

Current law requires certain insurance companies to offer terrorism insurance as part of a property and casualty insurance policy through calendar year 2005. H.R. 4634 would extend the requirement to offer terrorism insurance through calendar year 2007. Under the bill, insurers that offer group life insurance would be required to include coverage of terrorist incidents. According to industry representatives, the direct cost for insurance companies to continue making terrorism insurance available under property and casualty policies and for group life insurers to offer such insurance would be minimal. The bill would only require that firms offer terrorism insurance, but they would set their own premium rates and policyholders could choose whether or not to purchase such insurance. Insurers who offer terrorism insurance would receive financial assistance to cover a portion of their losses in the event of a terrorist attack.

Repayment of Assistance

The bill would extend the requirement that the federal government recoup some of the costs of such financial assistance provided to certain insurers and the government's authority to make assessments sufficient to recover all federal payments. Those costs would be recouped through future surcharges paid by the insurance industry. The bill also would expand the requirement to include purchasers of group life insurance.

Taken individually, some insurers might benefit from the financial assistance, while others might face only the cost of the surcharges. But for the insurance industry as a whole, the cost of the surcharges would be no greater than the financial assistance received, so the net cost of this mandate would be zero.

Preemption of State Law

The bill also would preempt some state laws regulating insurance. Based on information from state insurance regulators, CBO estimates that the cost of extending those preemptions would be minimal.

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