CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

January 4, 2006

S. 467
Terrorism Risk Insurance Extension Act of 2005

As cleared by the Congress on December 17, 2005, and signed by the President on December 22, 2005

SUMMARY

S. 467 (enacted as Public Law 109-144) extends the Terrorism Risk Insurance Act (TRIA) through calendar year 2007 but excludes certain lines of insurance coverage formerly offered under TRIA. First 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 helps insurers cover losses in the event of a terrorist attack under certain conditions. Prior to enactment of S. 467, TRIA would have expired at the end of calendar year 2005.

There is no reliable way to predict how much insured damage terrorists might cause in any specific year. Rather, CBO's estimate of the cost of financial assistance provided under S. 467 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 losses from providing this insurance, although firms do not pay any premium for the federal assistance offered by TRIA.

On this basis, CBO estimates that S. 467 will increase direct spending by about $1.4 billion over the 2006-2010 period and by $1.5 billion over the next 10 years. Under TRIA, the Department of the Treasury would recoup some or all of the costs of providing financial assistance through charges imposed on insurance firms (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 of the Treasury would not impose any surcharges until two years after federal assistance is provided and that those amounts would be collected over several years. Thus, CBO estimates that S. 467 will increase governmental receipts by about $150 million over the 2006-2010 period and by $720 million over the next 10 years.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of S. 467 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									
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
CHANGES IN DIRECT SPENDING										
Estimated Budget Authority	210	460	390	210	110	70	40	30	10	10
Estimated Outlays	210	460	390	210	110	70	40	30	10	10
CHANGES IN REVENUES										
Estimated Revenues	0	0	20	50	80	100	110	120	120	120

BASIS OF ESTIMATE

CBO estimates that enacting S. 467 will increase direct spending by $1.5 billion and governmental revenues by $720 million over the 2006-2015 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.

S. 467 extends the Terrorism Risk Insurance Act through calendar year 2007. TRIA provides up to $100 billion in financial assistance (less insurer payments) to commercial property and casualty insurers for losses above certain thresholds due to certain types of future terrorist acts. Such 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.

Under S. 467, the minimum amount of insured damages necessary to qualify for TRIA coverage increases to $50 million in 2006 and $100 million in 2007, but certain types of insurance that were formerly covered by TRIA are now excluded. In addition, commercial property and casualty insurance policies are allowed to 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 increased each year under TRIA and continue to increase under S. 467, 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 a portion of claims above the deductible amount up to $100 billion in total insured losses. Under S. 467, the federal government's share of claims above the deductible amount is 90 percent in 2006 and 85 percent in 2007. Insurers would be responsible for the remaining 10 percent in 2006 and 15 percent in 2007. The federal government would impose future surcharges on the insurance industry to recoup some of the costs of federal assistance and has 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, S. 467 exposes the federal government to potentially large liabilities for two more years (2006 and 2007). For any particular year, the amount of insured damage caused by terrorists could range from zero to many billions of dollars. CBO's estimate of the cost of this program reflects how much, on average, the government could be expected to pay to insurers.

The following sections describe our method for estimating the expected value of financial assistance under S. 467 and explain how we convert that 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 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 very 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 TRIA coverage is about $2 billion (in 2006 dollars). This estimate incorporates industry expectations of the probabilities of terrorist attacks, encompassing the possibility of attacks that result in enormous loss of life and property damage as well as the likelihood that no such attacks would occur. This estimate also reflects our expectation that some portion of losses from terrorism would not be covered by TRIA because some policyholders will choose not to purchase insurance coverage for terrorism risks.

S. 467 excludes commercial automobile insurance, burglary and theft insurance, surety insurance, professional liability insurance, and farm owners' multiple peril insurance from coverage under TRIA. Because those lines of insurance were covered by TRIA until December 31, 2005, excluding them could potentially reduce the government's liability in the event of a terrorist attack. However, according to industry experts, losses from those lines of coverage are highly unlikely to make up a significant portion of losses from a terrorist attack. For this reason, CBO expects that excluding those insurance lines would have an insignificant effect on average annual losses as compared to the coverage provided before enactment of S. 467.

CBO's estimate assumes that, in most years, losses from terrorist attacks covered by TRIA will cost less than $2 billion. We expect that there is a significant probability that no terrorist attacks covered by TRIA will 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 causing losses similar in scale to those sustained on September 11, 2001, in New York City (an estimated $20 billion) are likely to occur very rarely.[1]

Determining the federal share of insured losses. Federal payments under TRIA will be lower than the total insured losses from terrorist attacks because TRIA places limits on eligibility for federal assistance and requires that insurers pay a share of covered losses. To estimate

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.

federal spending under TRIA, CBO adjusted the expected value of annual insured losses from future terrorist attacks to account for these requirements.

First, because federal payments under TRIA do not apply to losses that exceed $100 billion per event, we excluded costs for potential losses above that level. Under S. 467, the minimum losses that would trigger federal payments under TRIA are $50 million in 2006 and $100 million in 2007. Although that minimum was $5 million before enactment of S. 467, CBO expects that insured losses below $100 million would most likely be covered by insurers' deductibles. Therefore, we estimate that the new higher minimum thresholds for federal assistance would not significantly change federal payments under TRIA.

Second, we accounted for the share of losses that affected insurers would pay in the event of a covered attack. Before the federal government makes any payments under TRIA, an insurer suffering losses will first pay claims up to a deductible, calculated as a specified percentage of its annual property and casualty insurance premiums (17.5 percent in 2006 and 20 percent in 2007). Once affected insurers have paid claims up to their deductibles, the federal government will share a portion of the losses above the deductible with each insurer. That portion is 90 percent in 2006 and 85 percent in 2007.

The total amount of claims paid by insurers through deductibles could range from a few million dollars to several billion dollars, depending on how many insurers provide coverage for losses resulting from a given terrorist attack. In addition, the value of each individual insurer's deductible would vary greatly across the industry. For this estimate, CBO considered a range of possibilities regarding the share of federal assistance, based on industry data regarding estimated insurers' deductibles under S. 467. The range encompasses the possibility that an attack would affect only a few insurers with relatively small deductibles or several insurers with relatively large deductibles.

CBO estimates that the Secretary would need to charge about $870 million in calendar year 2006 and $850 million in calendar year 2007 to fully compensate the government for the projected average annual cost of losses due to terrorist attacks under S. 467. In total, CBO estimates that the expected cost to the government of enacting S. 467 is about $1.7 billion (before considering the revenues from surcharges on policy holders). 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 S. 467 will cost about $1.4 billion over the 2006-2010 period, $160 million over the 2011-2015 period, and $180 million after 2015. 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 assume 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 S. 467, CBO estimates that the Secretary of the Treasury would impose surcharges on policyholders that would increase revenues by $720 million over the 2006-2015 period. Surcharges could continue for many years beyond 2015.

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. S. 467 requires the Secretary to recoup federal assistance up to a fixed "retention amount" set in the act, less the amount already paid by insurers through the insurer deductibles and the percent share of losses over the deductibles assigned to insurance firms (10 percent in 2006 and 15 percent in 2007). That retention amount was $15 billion in 2005. Under S. 467, the retention amounts are $25 billion in 2006 and $27.5 billion in 2007. The Secretary of the Treasury also has 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 accomplished 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 its aggregate premiums. S. 467 directs 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 total surcharges resulting from the two-year extension of TRIA will total $1.6 billion.

Timing and tax offset. CBO expects that the Secretary probably would not collect all of the estimated $1.6 billion of surcharges during the 2006-2015 period. The act allows the Secretary to reduce annual charges after 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 S. 467. Thus, we estimate that surcharges will total $950 million over the next 10 years and that an additional $680 million will be collected after 2015.

Consistent with standard procedures for estimating the revenue impact of indirect business taxes, CBO reduced the gross revenue impact of the insurance surcharges by 25 percent to reflect offsetting effects on income and payroll tax receipts. CBO estimates that S. 467 will increase revenues by a total of $720 million over the next 10 years and that an additional $500 million will be collected after 2015, net of income and payroll tax offsets.

PREVIOUS CBO ESTIMATE

On December 14, 2005, CBO transmitted a cost estimated for S. 467, the Terrorism Risk Insurance Extension Act of 2005, as passed by the Senate on November 18, 2005. Both versions of the legislation would extend TRIA for two years, providing up to $100 billion in financial assistance to insurers for losses above certain minimum thresholds. Our estimate of spending under both pieces of legislation is identical.

The version of the legislation passed by the Senate on November 18, 2005, would have set the "industry retention" level (the maximum amount of claims covered by the industry) at $17.5 billion in 2006 and $20 billion in 2007; the enacted version sets the industry retention level at $25 billion in 2006 and $27.5 billion in 2007. Because the enacted version requires insurers to repay more federal assistance through surcharges, CBO estimates that the revenues collected from surcharges will be higher than the amounts that would have been collected under the version passed by the Senate in November. However, CBO's cost estimate for the revenue impact of the version passed by the Senate in November did not account for the impact of such indirect business taxes on other tax revenues. This estimate for the enacted version of S. 467 reflects both the different levels for industry retention and a 25 percent offset to the surcharges to account for their impact on income and payroll taxes.

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