



# Renegotiation of the Standard Reinsurance Agreement (SRA) for Federal Crop Insurance

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## Summary

Under the federal crop insurance program, farmers can purchase crop insurance policies to manage financial risks associated with declines in crop yields and/or revenue. The program covers more than 100 crops and is administered by the U.S. Department of Agriculture's (USDA's) Risk Management Agency (RMA), which acts as both regulator and reinsurer. To encourage farmer participation and reduce the need for ad hoc disaster assistance, the federal government subsidizes the purchase of crop insurance policies, which are sold and serviced through 16 approved private insurance companies. Insurance company losses are reinsured by USDA, and their administrative and operating (A&O) costs are reimbursed by the government.

A Standard Reinsurance Agreement (SRA) between USDA and the private companies spells out expense reimbursements and risk-sharing by the government, including the terms under which the government provides subsidies and reinsurance (i.e., insurance for insurance companies) on eligible crop insurance contracts sold or reinsured by insurance companies. As a result, the SRA plays a central role in determining program costs. The SRA does not affect policy premiums paid by farmers, which are based on RMA's estimates of risk and on subsidies set in statute.

As provided under the 2008 farm bill, USDA in late 2009 began renegotiating the SRA established in 2004. On July 13, 2010, USDA announced that all of the approved crop insurance companies had signed the new SRA, which covers crops with policy closing dates after July 1, 2010 (e.g., 2011-crop corn). Prior to and during the negotiations, some had criticized the previous SRA as being too generous for insurance companies following a significant increase in government costs in recent years. Although Congress does not directly approve any new agreement, Congress has been interested in its oversight capacity, particularly with respect to cost-effectiveness and effects on farmer participation, the industry's selling and servicing of crop insurance products to farmers, and baseline funding levels for the next farm bill.

Since A&O reimbursements under the previous SRA were based on a percentage of premiums, their dollar amount had risen sharply in recent years as premiums rose to reflect higher crop prices. The A&O reimbursement increased from an average of \$881 million during FY2004-FY2006 to \$1.6 billion in 2009. Similarly, company underwriting gains (the amount by which a company's share of retained premiums exceeds its indemnities) have increased substantially in recent years, as weather has been generally favorable for growing crops. Some have argued that if the government share of gains is increased in exchange for a larger government share of losses, average taxpayer costs would decline. The insurance industry has contended that a certain SRA provision ("net book quota share") is a tax on underwriting income and crowds out private reinsurance.

RMA released its first draft of the 2011 SRA on December 4, 2009, a second draft in mid-February 2010, and a "final" draft on June 10, 2010. The final SRA places a cap on A&O reimbursements to control costs, and limits a company's expenditures on agent commissions. Among the changes to underwriting provisions, the final SRA improves profit potential and reduces company risk in higher-risk and underserved states. Overall, USDA expects the changes to save \$6 billion over 10 years. The industry remains concerned that funding reductions are excessive, potentially jeopardizing program delivery to farmers.

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## Introduction

Under the federal crop insurance program, farmers can purchase crop insurance policies to manage financial risks associated with declines in crop yields and/or revenue. The program, which began in 1938 when Congress authorized the Federal Crop Insurance Corporation (FCIC) and now covers more than 100 crops, is administered by the U.S. Department of Agriculture's (USDA's) Risk Management Agency (RMA), which acts as both regulator and reinsurer.

A Standard Reinsurance Agreement (SRA) between USDA and the private companies spells out expense reimbursements and risk-sharing by the federal government, including the terms under which FCIC provides subsidies and reinsurance (i.e., insurance for insurance companies) on eligible crop insurance contracts sold or reinsured by insurance companies. As a result, the SRA plays a central role in determining program costs.

In late 2009, RMA began the process of renegotiating the SRA established in 2004. In the run-up to the negotiations, some had criticized it as being too generous for insurance companies following a significant increase in government costs in recent years, driven in part by rising crop prices. The 2008 farm bill (P.L. 110-246) allows USDA to renegotiate the SRA once every five years starting with the 2011 reinsurance year (which runs from July 1, 2010, through June 30, 2011).<sup>1</sup>

The negotiation process involved USDA developing a draft agreement, meeting separately with the insurance companies, and responding to the comments, concerns, and suggestions of the insurance companies and the public. On June 10, 2010, RMA issued what it called the final draft of a new SRA to cover the 2011 reinsurance year and subsequent years.<sup>2</sup> On July 13, 2010, USDA announced that the agreement had been signed by all 16 approved insurance companies, putting it into effect for the 2011 reinsurance year.

This report discusses federal crop insurance costs, the SRA that had been in effect for the 2010 reinsurance year, and issues related to the renegotiation of the SRA. Although Congress does not directly approve any new agreement, Congress has been interested in the SRA negotiation in an oversight capacity, particularly with respect to cost-effectiveness and changes that might affect farmer participation, policy coverage, or industry interest in selling crop insurance to farmers.<sup>3</sup> Another congressional concern has been how cuts in crop insurance expenditures stemming from a new SRA might affect baseline spending levels used for determining funding for the next farm bill.<sup>4</sup>

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<sup>1</sup> The reinsurance year for a crop insurance policy is determined by its sales closing date. For example, a policy for 2010-crop corn is covered under the 2010 standard reinsurance agreement because the sales closing date is March 15, 2010 (in most cases).

<sup>2</sup> U.S. Department of Agriculture, "USDA Releases Final Draft Crop Insurance Agreement," press release, June 10, 2010, <http://www.usda.gov/wps/portal/usda/usdahome?contentidonly=true&contentid=2010/06/0316.xml>.

<sup>3</sup> Office of Senator Blanche Lincoln, "Lincoln, Chambliss Urge USDA to Revisit Crop Insurance Changes," press release, January 20, 2010. See also Office of U.S. Representative Stephanie Herseth Sandlin, "Herseth Sandlin Works to Ensure Producer Access to Crop Insurance," press release, January 22, 2010.

<sup>4</sup> Jerry Hagstrom, "Peterson Floats Reconciliation for Farm Bill," *CongressDaily*, February 16, 2010, [http://www.nationaljournal.com/congressdaily/cop\\_20100216\\_5206.php](http://www.nationaljournal.com/congressdaily/cop_20100216_5206.php).

## Crop Insurance Background

Congress first authorized federal crop insurance as an experiment to address the effects of the Great Depression and crop losses in the Dust Bowl. In 1938, the Federal Crop Insurance Corporation (FCIC) was created to carry out the program, which focused on major crops in major producing regions. The federal crop insurance program remained limited until passage of the Federal Crop Insurance Act of 1980 (P.L. 96-365), which expanded crop insurance to many more crops and regions of the country. Congress enhanced the crop insurance program in 1994 and again in 2000 to encourage greater participation. The changes also expanded the role of the private sector in developing new products that would help farmers manage their risks.

To encourage farmer participation and reduce the need for ad hoc disaster assistance, the federal government subsidizes the purchase of crop insurance policies, which are sold and completely serviced through 16 approved private insurance companies. Independent insurance agents are paid sales commissions by the companies. Insurance company losses are reinsured by USDA, and their administrative and operating costs are reimbursed by the federal government. These costs include payroll, rent, commissions to agents, and expenses for adjusting claims (e.g., traveling to farmers' fields).

The SRA does not affect policy premiums paid by farmers, which are based on RMA's estimates of risk and on subsidies set in statute. The premiums depend in part on crop price levels, coverage levels that producers select, and policy type (e.g., yield-based or revenue-based). The expense reimbursement is currently calculated as a share of policy premiums. For more information on crop insurance policies, see CRS Report R40532, *Federal Crop Insurance: Background and Issues*, by Dennis A. Shields.

## Federal Program Costs

Federal program costs for crop insurance fall into one of four main categories: premium subsidies, administrative and operating (A&O) expense reimbursement, program losses (or gains), and other (**Table 1**). The SRA essentially defines the parameters that eventually determine A&O expense reimbursements and program losses (or gains). Premium subsidies are specified in the Federal Crop Insurance Act of 1980 (P.L. 110-365), as amended. Periodic legislation can also affect federal outlays (see "A&O Reimbursement," below).

The largest cost category is premium subsidies, which lower the cost to farmers of purchasing insurance policies. When purchasing a policy, a producer growing an insurable crop selects a level of coverage and pays a portion of the premium. The remainder of the premium is covered by the federal government. Nearly 60% of total premium, on average, is paid by the government. As with other insurance, premiums increase with additional coverage, in terms of greater price protection or yield protection (or both).

The second-largest cost category is A&O expense reimbursement. Unlike some other insurance products, premiums for crop insurance are not "expense loaded." For crop insurance, the entire premium covers only the liability associated with payment of crop losses and excludes expenses for delivery of the product. Currently, expense reimbursement for insurance companies is directly related to the value of the premiums. Therefore, as premiums rise, so does the A&O expense reimbursement, even if other factors, such as the number of policies sold, remain unchanged.

The third category is program losses. As a reinsurer, the federal government is liable for insured losses as agreed to in the current SRA. In a number of recent years, the government has received a gain because of relatively favorable weather.

The fourth category is other expenses such as RMA salaries and benefits or costs associated with research and development activities, which typically account for a small portion of total costs.

**Table 1. Government Cost of Federal Crop Insurance**  
(millions of dollars)

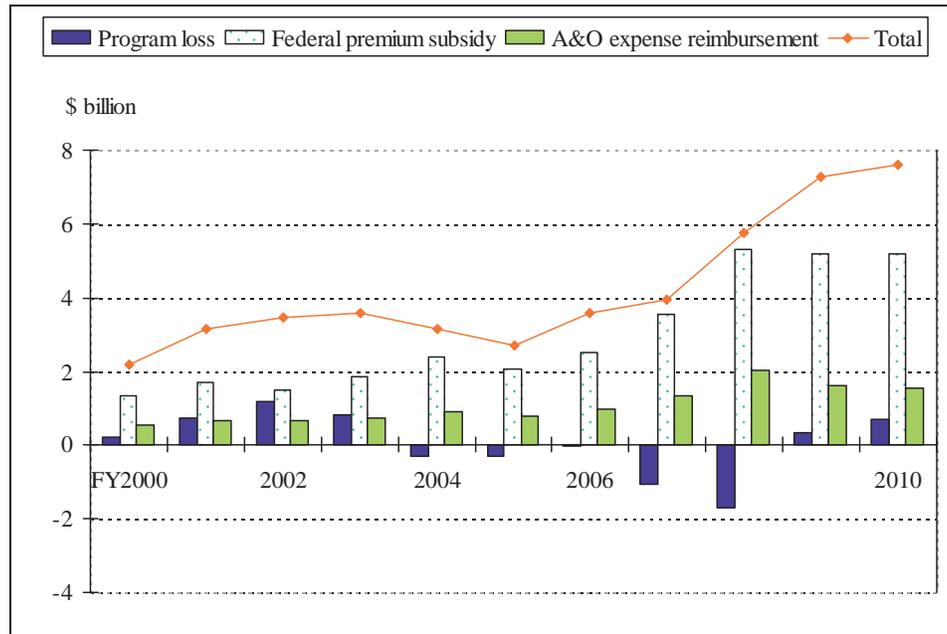
Fiscal Year	Federal Premium Subsidy	Private Company A&O Expense Reimbursements <sup>a</sup>	Program Losses or (Gains) <sup>b</sup>	Other Costs <sup>c</sup>	Total Government Cost
2000	1,353	540	196	86	2,175
2001	1,707	648	725	82	3,162
2002	1,513	656	1,182	115	3,466
2003	1,874	743	822	149	3,588
2004	2,387	900	(305)	143	3,125
2005	2,070	783	(293)	139	2,699
2006	2,517	960	(31)	125	3,571
2007	3,544	1,341	(1,068)	123	3,940
2008	5,301	2,016	(1,717)	137	5,737
2009	5,198	1,602	340	131	7,271
2010 (forecast)	5,201	1,546	682	155	7,584

**Source:** U.S. Department of Agriculture, Risk Management Agency.

- a. A&O = administrative and operating.
- b. Government's underwriting loss (gain if negative) = the difference between total indemnity payments for crop losses and total premiums (farmer- and government-paid), plus or minus any private company underwriting losses or gains.
- c. Other costs primarily include federal salaries of USDA's Risk Management Agency and, beginning in 2002, various research and development initiatives mandated by the Agriculture Risk Protection Act of 2000 (P.L. 106-224).

In recent years, government costs for crop insurance have increased substantially (**Figure 1**). After ranging between \$2.1 and \$3.6 billion annually during FY2000-FY2006, costs rose to \$5.7 billion in FY2008 and more than \$7 billion in FY2009 as higher policy premiums from rising crop prices drove up premium subsidies for farmers and expense reimbursements to private insurance companies.<sup>5</sup>

<sup>5</sup> Expenditures in a particular fiscal year mainly reflect the expenditures associated with the previous crop year (since fall harvest overlaps with the beginning of the fiscal year).

**Figure I. Government Costs for Crop Insurance Have Increased Sharply**

**Source:** U.S. Department of Agriculture, Risk Management Agency.

**Notes:** 2010 forecast. Total includes small amounts of “other” costs. For program losses, a negative number indicates an underwriting gain, which reduces total government costs.

## Major Provisions in the Standard Reinsurance Agreement for 2010

The Standard Reinsurance Agreement is a cooperative financial agreement between FCIC and each of the approved crop insurance companies to deliver eligible crop insurance contracts. It becomes effective upon its execution and FCIC’s approval of the company’s plan of operations for the applicable reinsurance year.

The SRA for the 2010 reinsurance year (ending June 30, 2010) contains four sections: definitions (see box, “Selected Terms Defined in the Standard Reinsurance Agreement”), reinsurance, A&O expense reimbursement, and general provisions.<sup>6</sup>

### Reinsurance

The 2010 SRA establishes terms for the type of insurance contracts that will be reinsured and subsidized. In general, in order to prevent companies from “cherry-picking” the most profitable policies, an insurance company must offer and market all plans of insurance for all crops in any state in which the company writes a crop insurance contract, provided that RMA actuarial

<sup>6</sup> U.S. Department of Agriculture, Risk Management Agency, *Standard Reinsurance Agreement between the Federal Crop Insurance Corporation and the (Insurance Company Name) (City and State)*, [http://www.rma.usda.gov/pubs/ra/05sra\\_final.pdf](http://www.rma.usda.gov/pubs/ra/05sra_final.pdf).

documents are available in that state.<sup>7</sup> A company must also accept and approve applications from all eligible producers, and it is prohibited from providing a rebate (money, goods, or any other benefit) in exchange for purchasing a policy. Employees and agents of the company must also be properly licensed by the state in which they are doing business, if required by the state. Only the amount of net book premium—defined as the total premium calculated for all eligible crop insurance contracts, less A&O subsidy and fees—in the company’s approved plan of operations may be reinsured and subsidized under the agreement.

### **Selected Terms Defined in the 2010 Standard Reinsurance Agreement**

**A&O subsidy**—the subsidy for the administrative and operating expenses paid by FCIC on behalf of the policyholder to the company for eligible crop insurance contracts.

**Administrative fee**—the processing fee the policyholder must pay under an eligible crop insurance contract.

**Book of business**—the aggregation of all eligible crop insurance contracts in force between the company and its policyholders that have a sales closing date within the reinsurance year and are eligible to be reinsured under the SRA.

**Cede**—to pass to another all or part of the net book premium and associated liability for ultimate net losses on eligible crop insurance contracts.

**Eligible producer**—a person who has an insurable interest in an agricultural commodity, who has not been determined ineligible to participate in the federal crop insurance program, and who possesses a U.S.-issued social security number (SSN) or employer identification number (EIN).

**Loss ratio**—the ratio calculated by dividing the ultimate net loss by the net book premium, expressed as a percentage. For example, the ratio of \$1 ultimate net loss to 50 cents net book premium would be expressed as 200%.

**Net book premium**—the total premium calculated for all eligible crop insurance contracts, less A&O subsidy, cancellations, adjustments, and administrative fees.

**Plan of operations**—documents and financial information the company must submit annually to FCIC for approval. The information includes identification of company officials, declarations on retention amounts, and expenses for business reinsured under the agreement for the previous calendar year.

**Producer premium**—that portion of the premium for an eligible crop insurance contract payable by the policyholder.

**Retained**—as applied to ultimate net losses, net book premium, or book of business, means the remaining liability for ultimate net losses and the right to net book premiums after all reinsurance ceded to FCIC under this agreement.

**Risk subsidy**—that portion of the premium for an eligible crop insurance contract paid by FCIC on behalf of the policyholder.

**Ultimate net loss**—the amount paid by a company under any eligible crop insurance contract reinsured under the SRA in settlement of any claim, less any recovery or salvage by the company.

**Underwriting**—the determination of the terms and conditions by which the company will accept the risk for an eligible crop insurance contract.

**Underwriting gain (loss)**—the amount by which a company’s share of retained net book premium exceeds (falls short of) its retained ultimate net losses.

**Source:** U.S. Department of Agriculture, Risk Management Agency, *Standard Reinsurance Agreement between the Federal Crop Insurance Corporation and the (Insurance Company Name) (City and State)*, [http://www.rma.usda.gov/pubs/ra/05sra\\_final.pdf](http://www.rma.usda.gov/pubs/ra/05sra_final.pdf).

<sup>7</sup> However, companies reportedly steer agents to more profitable business through commissions.

The 2010 SRA defines risk-sharing between the government and private insurance companies. Under the SRA, insurance companies may transfer some liability associated with riskier policies to the government and retain profits/losses from less risky policies. This transfer of risk is accomplished through a set of reinsurance funds maintained by FCIC. Within 30 days of the sales closing dates for each crop, companies assign each policy they sell to one of three funds—assigned risk, developmental, or commercial—for each state. Each company then decides what proportion of premiums (and potential for losses/gains) to retain within each reinsurance fund, subject to required minimum retention limits of individual funds.<sup>8</sup> The ceded (i.e., not retained) portion goes to the government. Overall, a company must retain at least 35% of its book of business.

### **Assigned Risk Fund**

The assigned risk fund is used for policies believed to be high-risk; it helps ensure that benefits of the federal crop insurance program are extended to all eligible farmers, regardless of risk. Depending on the state where the policy is sold, companies may retain as little as 15% to 25% of their highest-risk business, as specified in the 2010 SRA. Consequently, the federal government assumes a large portion of liability associated with high-risk policies. The SRA also specifies limits on the proportion of a company's business that may be placed in the assigned risk fund.

### **Developmental Fund**

When the assigned risk designation limit is reached, companies allocate policies—particularly medium-risk policies and pilot programs—to the developmental fund. Each company decides what proportion of its business (by plan type and state) to retain, ranging from 35% to 100%.

### **Commercial Fund**

The commercial fund is for policies for which companies expect to have only a small amount of losses. The companies select to retain (by plan type and state) between 50% and 100% of premium and associated liability of policies in the commercial fund. In 2008, about 20% of total premium value was placed in assigned risk, 10% in developmental, and 70% in commercial.

Following the allocation of policies to one of the three funds, the actual gain/loss sharing for a company's retained business is based on loss ratios (indemnities paid divided by premiums collected) as established in the 2010 SRA. As a general rule, for underwriting losses, the higher the loss ratio, the lower the company share of losses (calculated separately for each fund within each state). This provision limits overall losses, with the government paying increasing amounts as losses mount. For example, FCIC assumes 100% of the underwriting loss for portions incurred when a company's loss ratio exceeds 500% (indemnities are five times greater than total premiums). Similarly, when there are underwriting gains, a company's share of gains declines (and the government's share increases) when the loss ratio is relatively low.

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<sup>8</sup> The developmental and commercial funds are further subdivided by insurance product type—catastrophic, buy-up, and revenue. (Retention percentages for each of the sub-categories may differ within a state.) For information on these policies, see CRS Report R40532, *Federal Crop Insurance: Background and Issues*, by Dennis A. Shields.

A company's shares of gains and losses also vary by fund. They are greatest in the commercial fund and the least in the assigned risk fund. Company exposure and potential gains are much greater in the commercial fund than in the assigned risk fund.

The final risk-sharing component of the 2010 SRA is the "net book quota share." Once a company's net gain or loss is calculated over its entire "book of business," the company must cede a 5% share of its cumulative underwriting gains/losses to the government. As a result, the government receives a portion of underwriting gains from a company's retained business (but will also pay a portion of the losses, if realized). Since the company's total book includes a higher proportion of policies with lower risk, this portion is generally a positive value, which offsets part of the government costs of the program (See **Table 1**, above, and "Cost Control and Financial Viability of Crop Insurance Companies," below).

## **A&O Reimbursement**

The SRA establishes the reimbursement rate for administrative and operating (A&O) expenses to private insurance companies. During 2006-2008, the reimbursement rate—defined as a percentage of net book premiums—ranged from 18.1% to 24.2%, with higher rates associated with lower levels of insurance coverage.<sup>9</sup> This means that for every \$100 in premiums collected, the companies received an administrative payment of \$18.10 to \$24.20 from the federal government.

To generate cost savings, Congress mandated a reduction in reimbursement rates in the Food, Conservation, and Energy Act of 2008 (P.L. 110-246, the 2008 farm bill, Sec. 12016(E)).<sup>10</sup> Beginning with the 2009 reinsurance year (July 1, 2008), the A&O reimbursement was reduced for most crop insurance policies by 2.3 percentage points, with the resultant rates ranging from 15.8% to 21.9%.<sup>11</sup> For a discussion on trends in the A&O reimbursement, see "Cost Control and Financial Viability of Crop Insurance Companies," below.

## **General Provisions**

An insurance company is required to collect and provide to FCIC data on policyholders, as well as producer premiums and administrative fees collected by the company. Monetary penalties are applied if the required information is not submitted timely or accurately. The company must also provide policyholders with a summary of coverage and a billing statement that prominently displays the policy premium, the FCIC-paid portion, and the administrative and operating (A&O)

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<sup>9</sup> See table 1 in U.S. Government Accountability Office, *Crop Insurance—Opportunities Exist to Reduce the Costs of Administering the Program*, Washington, DC, April 2009, <http://www.gao.gov/new.items/d09445.pdf>.

<sup>10</sup> CRS Report RL34207, *Crop Insurance and Disaster Assistance in the 2008 Farm Bill*, by Ralph M. Chite and Dennis A. Shields.

<sup>11</sup> U.S. Department of Agriculture, Risk Management Agency, *Amendment No. 1 to the Standard Reinsurance Agreement Effective Beginning with the 2009 Reinsurance Year*, <http://www.rma.usda.gov/pubs/ra/sraarchives/09sraamendment1.pdf>. Note that, for catastrophic (CAT) policies, the A&O reimbursement rate is zero, but FCIC pays companies an amount equal to 6% of net book premium for CAT policies for loss adjustment expenses. The farm bill also reduced (1) the A&O reimbursement rate to 12% for any plan of insurance that is based on area-wide losses, and (2) the target loss ratio (indemnities paid divided by premiums collected) from 1.075 to 1.00. In states with a gross loss ratio of 120% in any year, the A&O reduction is 1.15%, not the full 2.3%. This is presumably intended to cover additional costs of servicing additional claims in that state.

reimbursement paid by FCIC. The company must also follow FCIC regulations and procedures for a host of activities, including verification of yields and other information used to establish insurance guarantees and indemnity payments.

## Studies on Rates of Return

As part of USDA's preparation for renegotiating the SRA, the department hired a firm to calculate rates of return for crop insurers. In a two-part study, Milliman, Inc., estimated historical rates of return on equity for crop insurers and "reasonable" rates of return in order to determine if crop insurers are being over- or undercompensated by the government.<sup>12</sup> The reasonable rate of return was defined as the "cost of capital" or, in this case, the returns received by property and casualty insurers, which was considered to be an investment of equivalent risk.

The study concluded that the historical returns on equity for crop insurers averaged 16.6% during 1989 to 2008, or 3.8% above the average "reasonable" rate of return over the same period, which was estimated at 12.8%. In addition, during the 20-year period under examination, the calculated historical rate of return was above the calculated "reasonable" rate in all but three years, with historical returns negative in only one year (1993) because of massive flooding. If a second catastrophic year had occurred during the period, the study notes, the average historical rate of return would have declined to 15.6%. The crop insurance industry has criticized the Milliman study for failing to consider reinsurance and actual A&O costs.

The crop insurance industry completed its own analysis, which defined profitability relative to premiums or "sales" rather than relative to equity. The study, conducted by Grant Thornton LLP, measured profitability as pre-tax net income as a percentage of net retained premium.<sup>13</sup> The ratio for the 1992-2008 period averaged 14.2% for the crop insurance industry, compared with 17.5% for the property and casualty industry. USDA has criticized the Grant Thornton study for ignoring investment income on policyholder surplus when assessing returns on crop insurance.

## Issues in the SRA Renegotiation

The SRA renegotiation addressed several issues raised by policymakers, the agriculture community, and the crop insurance industry. These include control of government costs and financial viability of the crop insurance industry, crop insurance availability and farmer participation, and uncertainties after completion of the SRA renegotiation.

Any cost reductions imposed by the new SRA would be in addition to reductions mandated under the 2008 farm bill. These changes resulted in net budget outlay savings of \$3.9 billion over five years (FY2008-FY2012), or \$5.6 billion over 10 years (FY2008-FY2017), relative to the March

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<sup>12</sup> Milliman, Inc., *Historical Rate of Return Analysis*, August 18, 2009, <http://www.rma.usda.gov/pubs/2009/millimanhistoricalrate.pdf> (numbers cited in text above reflect revised data reported at <http://www.rma.usda.gov/pubs/2009/millimanhistoricalratetable8.pdf>); and Milliman, Inc., *Rate of Return Update—2008: Reasonable Rate of Return*, Task Order #20692, June 23, 2009, <http://www.rma.usda.gov/pubs/2009/millimanreasonable.pdf>.

<sup>13</sup> Grant Thornton LLP, *Federal Crop Insurance Program Profitability and Effectiveness Analysis*, prepared on behalf of National Crop Insurance Services, Inc., October 2, 2009, [http://www.ag-risk.org/NCIS PUBS/SpecRPTS/GrantThornton/Grant\\_Thornton\\_Report-2009\\_FINAL.pdf](http://www.ag-risk.org/NCIS PUBS/SpecRPTS/GrantThornton/Grant_Thornton_Report-2009_FINAL.pdf).

2007 baseline, according to the Congressional Budget Office. Approximately \$2.8 billion of this estimated five-year savings was attributable to changes in the timing of premium receipts from farmers, and payments to the participating insurance companies.

## **Cost Control and Financial Viability of Crop Insurance Companies**

### **A&O Reimbursements**

Since A&O reimbursements are based on a percentage of premiums, the dollar amount of A&O reimbursement has risen sharply in recent years as premiums have risen to reflect higher crop prices. The A&O reimbursement increased from an average of \$881 million during FY2004-FY2006 to \$1.6 billion in FY2009, after reaching \$1.3 billion in FY2007 and \$2.0 billion in FY2008. RMA data also indicate that A&O reimbursement per policy more than doubled from \$750 during 2004-2006 to \$1,748 in 2008.

Some observers have argued that the reimbursement rate should be pegged to something other than premium value, such as a flat fee per policy sold, to better reflect actual costs and to help reduce federal expenditures. If policies are actuarially sound, critics say, the administrative costs of writing and servicing a policy are generally not proportional to the value of the policy (e.g., whether 10 acres or 1,000 acres, or \$3 per bushel or \$9 per bushel).

The Government Accountability Office (GAO) released a study in April 2009 on costs associated with administering the crop insurance program.<sup>14</sup> GAO concluded that the current structure of A&O reimbursements “present[s] an opportunity to reduce government spending without compromising the crop insurance program’s safety net for farmers.” The current approach using crop prices, GAO says, has generated a “kind of windfall” for many insurance agencies and agents, as the companies, using funds from increased levels of A&O reimbursements, pay higher commissions to compete for each other’s “book of business” and associated underwriting gains.

GAO reported that crop insurance companies have spent a large share of their higher A&O reimbursements on commission payments, partly in an effort to compete for business from other insurance agencies. Since the federal government, through RMA and FCIC, sets policy premiums and determines which products can be offered, insurance companies do not compete on product quality or price. Rather, they can offer independent insurance agents, who sell policies through multiple companies, higher commissions to increase the company’s market share. Some argue that increases in agent commissions in recent years amount to “excessive compensation” that is directly attributable to additional subsidies paid to crop insurance companies, and their absence would not have reduced the level of service provided by the industry.<sup>15</sup>

The private crop insurance companies contend that any reductions in the A&O reimbursement will negatively affect the industry and possibly jeopardize the delivery of crop insurance, particularly in high-risk areas. Analysis conducted on behalf of the National Crop Insurance Services, Inc., a not-for-profit organization representing more than 60 crop insurance companies,

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<sup>14</sup> U.S. Government Accountability Office, *Crop Insurance—Opportunities Exist to Reduce the Costs of Administering the Program*, Washington, DC, April 2009, <http://www.gao.gov/new.items/d09445.pdf>.

<sup>15</sup> Bruce A. Babcock, “Examining the Health of the U.S. Crop Insurance Industry,” *Iowa Ag Review*, vol. 15, no. 4 (Fall 2009), [http://www.card.iastate.edu/iowa\\_ag\\_review/fall\\_09/article1.aspx](http://www.card.iastate.edu/iowa_ag_review/fall_09/article1.aspx).

concluded that, although companies have cut expenses over time through efficiencies, A&O reimbursements have been consistently below actual expenses incurred by private insurers, with a shortfall of 1-2 percentage points in 2008. (Moreover, with crop prices declining from highs in recent years, A&O expense reimbursements declined in FY2009 and are projected to decline again in FY2010.) The analysis states that the inadequacy of the A&O reimbursements is absorbed through a reduction in company profits.<sup>16</sup> To address the volatile nature of A&O reimbursements and policy premiums resulting from fluctuating crop prices, the crop insurance industry proposed “smoothing” commodity prices for use in calculating reimbursement expenses.<sup>17</sup>

## **Underwriting**

Similarly, company underwriting gains (the amount by which a company’s share of retained premiums exceeds its indemnities) have increased substantially in recent years, as weather has been generally favorable for growing crops. During this period, increases in insured acreage and higher crop prices have also increased gross liability. Liability represents total exposure of the program, meaning that if all participating farmers suffer losses to the full extent of coverage, program indemnities would be the total liability.

To reduce government costs of the program, some have suggested that the new SRA could alter the amount of underwriting gains that companies return to the government.<sup>18</sup> They say that if the government share of gains is increased in exchange for a larger government share of the losses in loss years, average taxpayer costs would decline. The insurance industry contends that the net book quota share provision of the SRA is equivalent to a tax on underwriting income and crowds out private reinsurance. The industry wants to see it eliminated and wants the general underwriting gain and loss provisions to be revised to reduce the potential for unusually large gains or losses. The industry expects this approach to reduce disincentives for insurers to offer insurance in less profitable (high loss) states.

Insurance companies point out that since they do not set rates (RMA does), crop insurers cannot respond to underwriting losses by increasing their rates in subsequent years or limiting coverage as is done in the property and casualty insurance industry. Generally higher policyholder surplus requirements also have implications for the level of required reserves and the amount of retained underwriting gains for insurance companies.

## **Crop Insurance Availability and Farmer Participation**

A major concern for policymakers is maintaining crop insurance availability and farmer participation in the crop insurance program. Crop insurance is an important risk management tool for many of the nation’s farmers, and it complements to some extent other federal programs, such

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<sup>16</sup> Grant Thornton LLP, *Federal Crop Insurance Program Profitability and Effectiveness Analysis*, prepared on behalf of National Crop Insurance Services, Inc. , October 2, 2009, [http://www.ag-risk.org/NCISPUBS/SpecRPTS/GrantThornton/Grant\\_Thornton\\_Report-2009\\_FINAL.pdf](http://www.ag-risk.org/NCISPUBS/SpecRPTS/GrantThornton/Grant_Thornton_Report-2009_FINAL.pdf).

<sup>17</sup> National Crop Insurance Services, Inc., *Recommendations for the Standard Reinsurance Agreement*, Overland Park, KS, October 19, 2009, [http://www.ag-risk.org/NCISPUBS/SpecRPTS/Recommendations\\_for\\_the\\_Standard\\_Reinsurance\\_Agreement.pdf](http://www.ag-risk.org/NCISPUBS/SpecRPTS/Recommendations_for_the_Standard_Reinsurance_Agreement.pdf).

<sup>18</sup> Bruce A. Babcock, “Examining the Health of the U.S. Crop Insurance Industry,” *Iowa Ag Review*, vol. 15, no. 4 (Fall 2009), [http://www.card.iastate.edu/iowa\\_ag\\_review/fall\\_09/article1.aspx](http://www.card.iastate.edu/iowa_ag_review/fall_09/article1.aspx).

as direct and counter-cyclical payments.<sup>19</sup> Policies are offered for major crops in most counties where they are grown, and in 2009, federal crop insurance policies covered 265 million acres.

The crop insurance industry warns that in order to preserve both crop insurance availability and farmer participation, the basic structure of the SRA—for example, the number and operation of the existing reinsurance funds and minimum retention percentages—should remain unchanged. Stability in design is also desired, insurance companies say, so they and their reinsurers will remain interested in participating in the program. In contrast, some say that there is room for cuts without risking declines in company and farmer participation, because reimbursements, when adjusted for inflation, are substantially above levels of the recent past.

In some states, particularly those with small agricultural sectors such as Utah, Wyoming, and several states in the Northeast, relatively few companies offer policies because overhead costs (per policyholder) are relatively high and the opportunity for growth in sales is limited. To improve availability in these states, the crop insurance industry recommends considering a shift of A&O reimbursements toward underserved states and promotion of additional education programs for farmers.

## **Uncertainties After Completion of SRA Renegotiation**

The crop insurance industry contends that several developments not directly related to the SRA could create uncertainties for the industry. One issue is payment timing. In order to score savings in FY2012, the 2008 farm bill pushed back the date for government payments to companies for A&O reimbursements and pulled forward the date for producers' premium bills, which means that companies may need to secure additional short-term financing during the late summer/early fall period.

Another issue is general demand for crop insurance and the combined effect of lower commodity prices and reduced crop insurance acreage in 2009, which followed strong prices and increased plantings the previous year. The industry points to these declines and prospects for uncertain demand recovery with concern that expense reimbursement is already headed downward, along with reductions mandated in the 2008 farm bill, even without changes in the SRA.

Finally, RMA is currently reviewing its methodology for premium rate determination.<sup>20</sup> The industry is concerned that any change from the current method has the potential to alter the industry's profitability under the new SRA. Without knowing the final outcome of rate determinations, the crop insurance industry has been reluctant to embrace changes to the SRA that have the potential to adversely affect their operation and profitability. RMA counters that it strives to ensure that the policies are actuarially sound and in the best interest of the federal crop insurance program.

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<sup>19</sup> For details on farm commodity programs, see CRS Report RL34594, *Farm Commodity Programs in the 2008 Farm Bill*, by Jim Monke.

<sup>20</sup> On November 30, 2009, USDA's Risk Management Agency released a draft of a periodic review of RMA's premium rating methodology. The final report, dated March 15, 2010, "A Comprehensive Review of the RMA APH and COMBO Rating Methodology Final Report," and other studies are available at <http://www.rma.usda.gov/pubs/>.

## Developing the 2011 SRA

On December 4, 2009, USDA's Risk Management Agency (RMA) released its first draft of the 2011 SRA.<sup>21</sup> It was designed to serve as the starting point for negotiations with the crop insurance companies. Following industry feedback, USDA issued a second draft in mid-February and a "final draft" on June 10, 2010. On July 13, 2010, USDA announced that all of the approved crop insurance companies had signed the new SRA, which covers crops with policy closing dates after July 1, 2010 (e.g., 2011-crop corn).

### USDA's First Draft SRA

USDA's initial draft (December 4, 2009) provided a new method for calculating administrative and operating (A&O) expenses, which RMA expects would save federal money and reduce volatility in the level of reimbursements received by insurance companies. Rather than tying A&O reimbursements to the value of current premiums (and current crop prices), the new method would use 10-year average farm prices (fixed period of 1999-2008) for seven major commodities as published by USDA.<sup>22</sup> According to USDA, the new approach would result in A&O reimbursement levels comparable to those in 2005 and 2006 (i.e., before the major price run-up), which the department contends were adequate for delivering the program.

The draft also made significant changes in the underwriting provisions. First, at the operational level, the number of reinsurance funds under the draft would decline. According to the draft agreement, companies would place policies into either the "residual" fund for riskier policies (as designated by the insurance companies) or the "commercial" fund for less risky policies. The move would eliminate the marginally used developmental fund and three sub-funds in the commercial fund under the 2010 SRA (see "Major Provisions in the Standard Reinsurance Agreement for 2010," above). Importantly, the draft made the residual fund a nationwide fund, in contrast with the current assigned risk fund, which is state-based. By consolidating the highest-risk policies into a single national pool shared by all crop insurance companies, USDA would expect the loss performance to be more stable for the residual fund than for the current assigned risk fund. An individual company's share of the fund would depend on its share of total premiums.

For the commercial fund under the draft agreement, a significant change in the first draft was to group states with similar levels of risk (e.g., low or high frequency of loss).<sup>23</sup> According to USDA, the alignment as well as new risk-sharing provisions—which vary by state group—would increase opportunities for gains by private insurance companies in high-risk states (e.g., Plains states) while decreasing opportunities for gains in low-risk states (e.g., Corn Belt states). Overall, the changes were intended to increase competition in states that historically have been less profitable and are considered "underserved." Also, RMA said that it would assume a greater share

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<sup>21</sup> The first draft and a side-by-side comparison with the 2010 SRA are available at <http://www.rma.usda.gov/news/2009/12/sra.html>.

<sup>22</sup> The seven commodities are wheat, corn, soybeans, grain sorghum, barley, upland cotton, and rice. Current (not historical) prices would be used to calculate reimbursement rates for all other commodities.

<sup>23</sup> State groups are based on each state's historical underwriting performance, with group 1 having the best performance. The first draft defines state groups as: 1 = Illinois, Indiana, Iowa, Minnesota, and Nebraska; 2 = California; 3 = Kentucky, Ohio, Oregon, Tennessee, Washington, and Wisconsin; 4 = all other states.

of extreme losses (and gains), which would protect insurance companies from potentially catastrophic losses.

The initial draft also changed the “net book quota share”—the portion of overall company gain or loss that the government retains. The new amount proposed was 10%, up from 5% in the current SRA. USDA intends to return some of the additional underwriting gains to companies that reach underserved producers and areas. USDA says it does not need additional authority to reallocate underwriting gains.

According to USDA, the first draft would save \$4 billion over five years. The Administration’s FY2010 budget proposal, which incorporates USDA’s first draft of the SRA as an assumption for baseline projections, claimed savings of \$8 billion over 10 years.<sup>24</sup>

## **Industry Response to USDA’s First Draft**

In response to USDA’s first draft, the crop insurance industry immediately voiced concerns that the initial proposal “is way beyond the ability of most insurance companies to stay in business and will force companies to reduce staff and service to farmers.”<sup>25</sup> Subsequently, on January 20, 2010, National Crop Insurance Services, Inc. (NCIS), issued a lengthy written response to USDA’s initial proposal.<sup>26</sup> In commenting on the draft proposal, the industry stated a variety of concerns, primarily about proposed changes to A&O reimbursements and the underwriting provisions. NCIS believes that the overall funding reductions implied by the initial draft SRA are excessive and unacceptable to the industry, and that cuts in delivery expenses and underwriting gains would reduce industry returns well below the long-term average. Moreover, the industry said the proposed changes would sharply reduce the ability of insurance companies to serve all producers, particularly those in “underserved states,” and result in job loss in the crop insurance industry.

According to the industry, the proposed “fixed” formula for calculating A&O reimbursements does not account for current delivery costs or those incurred under the SRA in the coming years, such as additional computer and data reporting requirements. Aside from the level of A&O cuts, NCIS claimed that USDA does not have discretion to negotiate lower A&O rates because the 2008 farm bill “fixed” them. In its formal response, NCIS stated that A&O reimbursements must remain as provided in statute, although the industry indicated elsewhere that they are continuing to work with USDA to arrive at A&O cuts that are acceptable to both parties.

Regarding changes to provisions for underwriting gains and losses, the industry did not want the government to take on additional risk—specifically by RMA taking a larger portion of the gains and losses for the most profitable states<sup>27</sup>—and “crowd out” commercial reinsurance. In addition,

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<sup>24</sup> Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2011*, Washington, DC, February 1, 2010, p. 48, <http://www.whitehouse.gov/omb/budget/fy2011/assets/budget.pdf>. Subsequently, USDA officials revised their estimate of savings to \$8.4 billion over 10 years.

<sup>25</sup> “New Crop Insurance Plan: Less for Companies, More for Underserved,” *Agri-Pulse*, December 9, 2009, p. 8.

<sup>26</sup> National Crop Insurance Services, Inc., “Response to the Risk Management Agency’s Draft Standard Reinsurance Agreement Issued on December 4, 2009,” Overland Park, KS, January 20, 2010, <http://www.ag-risk.org/>. See also National Crop Insurance Services, “Fundamental Problems Exist with the USDA’s Proposed 2011 Standard Reinsurance Agreement,” press release, January 20, 2010, <http://www.ag-risk.org/PressRel/2010/NCIS01202010.htm>. See also comments by Keith Collins on FarmPolicy.com published February 2, 2010.

<sup>27</sup> These states are Illinois, Indiana, Iowa, Minnesota, and Nebraska (called “Group 1” in both USDA’s proposal and NCIS’s counterproposal).

the draft proposal, according to the industry, would have only a limited improvement in potential underwriting gains for low-return states. The overall effect of the proposed changes, according to the industry, would be a sharp reduction in potential net underwriting gains by the insurance companies and in incentives to expand in underserved markets, and a potential increase in the cost of reinsurance for crop insurance companies.

In its response, the industry proposed two options for changing the underwriting provisions. Both options retain the current assigned risk fund and provide for a commercial fund with gain/loss share provisions that would differ for each of two state groups (group 1 is Illinois, Indiana, Iowa, Minnesota, and Nebraska; group 2 is all other states). Option A would eliminate quota share and alter both the company share of risk (which would increase for group 1 and decrease for group 2) and the company share of gain (which would be reduced for group 1 and increased for group 2). Option B would increase quota share to 10% and increase (relative to Option A) the company share of gains in both groups, particularly group 2. The industry estimated that both proposals would reduce expected underwriting gains by about \$100 million annually.

Another industry concern is “regulatory risk.” According to the industry, the proposal would mandate items such as data reporting and other activities, yet procedures for them are not thoroughly defined in the draft agreement. The concern is that companies could be subject to severe penalties, including loss of A&O reimbursements and/or reinsurance, if procedures are not followed.

## **USDA’s Second Draft SRA**

On February 17, 2010, USDA issued a news release announcing the second draft of the Standard Reinsurance Agreement.<sup>28</sup> USDA said that the second draft, identified with the date of February 23, 2010, contained significant changes that reflected negotiations between RMA and the participating crop insurance companies, particularly with respect to the structure of A&O reimbursements and risk-sharing terms.

Regarding A&O reimbursements, USDA inserted a two-year phase-in period for the proposed changes for using historical crop prices when calculating reimbursement levels. Rather than shifting immediately to the historical prices series, crop prices would be increased by 10 percentage points in the first year of the SRA and by five percentage points in the second year. Also, companies would receive an additional 5% in A&O reimbursements for operations in lower-served and/or higher-risk states. In an attempt to assert some control over agent commissions and to avoid instability in an insurance company’s financial prospects, USDA also proposed a “soft cap” on agent commissions equal to no more than 80% of A&O reimbursements. The agreement would, however, allow profit sharing from underwriting gains.

In response to industry concerns that the commercial fund should be streamlined, the risk-sharing provisions in the second draft essentially reduced the number of state groups to only two—one for Corn Belt states and another group for all other states. Also, at the request of the crop insurance companies, the second draft provided more profit/loss sharing for policies in the

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<sup>28</sup> U.S. Department of Agriculture, “USDA Releases Second Draft of Proposed Crop Insurance Agreements,” press release, February 17, 2010, <http://www.usda.gov/wps/portal/usdahome?contentidonly=true&contentid=2010/02/0064.xml>. The second draft and a side-by-side comparison are available at <http://www.rma.usda.gov/news/2009/12/sra.html>.

commercial fund. For the residual fund (containing the highest-risk policies), USDA shifted its proposal from a nationwide, all-company pool to individual company pools so that companies would not be exposed to liability associated with policies sold by other companies. Finally, the net book quota share, which had been set at 10% in USDA's first draft, was set at 7.5%, compared with the current level of 5%. Under the second draft, up to 2.5% of any net book quota share would be distributed to companies operating in underserved states.

Together, these changes, according to USDA, would move the expected rate of return for insurance companies from 12% in the first draft to 14% in the second draft, but still below the historical level of more than 16%.

## **Budget Implications**

USDA estimated that the second draft would reduce federal crop insurance expenditures by \$6.9 billion over 10 years, or about 20% less than the savings estimated under the first draft. The initial feedback from the industry was mixed, noting that USDA had listened to the industry "to some extent," but arguing that the cost savings and associated impacts on the industry were still too great.<sup>29</sup>

Some Members of Congress, including the Chairman of the House Committee on Agriculture, remain concerned that cuts would reduce baseline funding levels for crop insurance, which could have a negative effect on overall spending for the next farm bill. If concerns about the federal budget deficit lead to a call for reduction in mandatory spending, including funds for agriculture, cuts made administratively by USDA would not count as savings for agriculture spending that the House and Senate Agriculture Committees would need to make. Following precedence for reflecting a portion of budget savings due to "rulemaking" or similar administrative action, some cost savings based on USDA's first draft of the SRA have already been incorporated in the current estimate of baseline spending by the Congressional Budget Office (CBO).

CBO baseline budget estimates will serve as the official benchmark for scoring the budgetary impacts of the next farm bill. (CBO's March 2007 baseline was used to score the 2008 farm bill.) CBO's baseline projections typically assume continuation of current farm bill policies under expected economic conditions, as well as ongoing rulemaking and administrative changes. In the most recent CBO baseline (March 2010), spending on crop insurance totals \$77.2 billion during FY2011-FY2020. This figure includes an estimated \$3.9 billion in savings resulting from a new SRA. Subsequent CBO baselines are expected to include updated estimates of the impacts of the SRA.

## **2011 SRA Signed by Companies**

On June 10, 2010, USDA announced the release of what it called the final draft agreement (subject to technical review).<sup>30</sup> On July 13, 2010, USDA announced that all of the approved crop

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<sup>29</sup> Jerry Hagstrom, "USDA Pitches Smaller Cut in Crop Insurance," *CongressDaily*, February 17, 2010, [http://www.nationaljournal.com/congressdaily/cop\\_20100217\\_1193.php](http://www.nationaljournal.com/congressdaily/cop_20100217_1193.php).

<sup>30</sup> The final draft, related documents, and a side-by-side comparison with the 2010 SRA and earlier drafts are available at <http://www.rma.usda.gov/news/2009/12/sra.html>.

insurance companies had signed the new SRA, making it effective for the reinsurance year beginning July 1, 2010.<sup>31</sup>

To control costs, the 2011 SRA places a cap on A&O reimbursements of \$1.3 billion per year. The cap is adjusted annually for inflation, reaching \$1.37 billion in 2015. The reference price concept proposed in earlier drafts was eliminated, and the A&O reimbursement is calculated using market prices as in the previous SRA. However, a minimum total A&O reimbursement of \$1 billion is intended to protect companies against low market prices. To ensure company financial solvency and to control what some consider excessive commissions, particularly in the Midwest, the final SRA limits a company's expenditures on agent commissions to 80% of the A&O reimbursement in each state. Companies can supplement commissions with profit sharing, but total agent compensation will be limited to 100% of A&O reimbursements at the state level. According to USDA, under the previous SRA, average commissions were 108% of A&O reimbursements, a level which USDA said increases financial risk for companies if they encounter significant losses.

Among the proposed changes to underwriting provisions, the 2011 SRA is designed to make crop insurance delivery in higher-risk states (generally outside the Corn Belt states) more attractive to insurance companies. The commercial fund state groupings remain the same as in the second draft, but risk-sharing terms for higher-risk states are altered to provide increased profit potential and reduced share of loss. Also, for the highest-risk policies, USDA has shifted back to an assigned risk fund for each state (and company) so companies can maintain stop-loss protection for major disasters in individual states, as provided under the previous SRA. Finally, the net book quota share, which had been set at 10% in USDA's first draft, would be set at 6.5%, compared with the previous level of 5%. Under the final SRA, 1.5 percentage points of any net book quota share would be distributed to companies operating in underserved states.

USDA estimates that the new SRA reduces federal crop insurance expenditures by \$6 billion over 10 years, using the Administration's February 2010 baseline.<sup>32</sup> The department has stated that \$4 billion of the savings would be used for deficit reduction and \$2 billion for risk management and conservation programs, including expansion of the Pasture, Rangeland, and Forage crop insurance program and a "good experience" discount for producers. USDA states that the new agreement generally maintains the A&O subsidy structure contained in the previous SRA but removes the possibility of "windfall" government payments based on commodity price spikes.<sup>33</sup> Although the insurance companies have signed the agreement, the insurance industry remains concerned about the potential impact of reduced funding on overall delivery of the program and quality of service to producers.

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<sup>31</sup> U.S. Department of Agriculture, "USDA Receives Signed Standard Reinsurance Agreements from all 16 Crop Insurance Companies," press release, July 13, 2010, <http://www.usda.gov/wps/portal/usda/usdahome?contentidonly=true&contentid=2010/07/0366.xml>.

<sup>32</sup> USDA estimates savings at \$5.3 billion relative to the 2009 baseline, which was used for cost estimates of earlier SRA drafts.

<sup>33</sup> For USDA and industry statements, see hearing testimony: U.S. Congress, House Committee on Agriculture, Subcommittee on General Farm Commodities and Risk Management, hearing to review the state of the crop insurance industry, 111<sup>th</sup> Cong., 2<sup>nd</sup> sess., July 22, 2010, <http://agriculture.house.gov/hearings/statements.html>.

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