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CROP INSURANCE

Opportunities Exist to Reduce Government Costs for Private-Sector Delivery





United States
General Accounting Office
Washington, D.C. 20548

**Resources, Community, and
Economic Development Division**

B-276150

April 17, 1997

Congressional Committees:

This report responds to the requirement in the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 (P.L. 103-354, Oct. 13, 1994) that GAO and the U.S. Department of Agriculture's Federal Crop Insurance Corporation (FCIC) jointly evaluate the financial arrangements between FCIC and participating insurance companies for delivering the crop insurance program to qualified producers. The report contains recommendations to the Secretary of Agriculture to reduce the government's costs for the crop insurance program.

The U.S. Department of Agriculture's Risk Management Agency will report on the adequacy of return on capital to companies selling crop insurance for the federal government and identify alternative reinsurance arrangements.

We are sending copies of this report to interested congressional committees; the Secretary of Agriculture; participating insurance companies; and the Director, Office of Management and Budget. We will also make copies available to others upon request. If you or your staff have any questions, I can be reached on (202) 512-5138. Major contributors to this report are listed in appendix X.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Robert A. Robinson".

Robert A. Robinson
Director, Food and
Agriculture Issues

B-276150

Congressional Committees

The Honorable Richard G. Lugar
Chairman

The Honorable Tom Harkin
Ranking Minority Member
Committee on Agriculture, Nutrition, and Forestry
United States Senate

The Honorable Robert F. (Bob) Smith
Chairman

The Honorable Charles W. Stenholm
Ranking Minority Member
Committee on Agriculture
House of Representatives

B-276150

Executive Summary

Purpose

Federal crop insurance protects participating farmers against the financial losses caused by events such as droughts, floods, hurricanes, and other natural disasters. In 1995, crop insurance premiums were about \$1.5 billion. The U.S. Department of Agriculture's (USDA) Risk Management Agency administers the federal crop insurance program through the Federal Crop Insurance Corporation (FCIC). Federal crop insurance offers farmers two primary types of insurance coverage. The first—called catastrophic insurance—provides protection against the extreme losses of crops for the payment of a \$50 processing fee, whereas the second—called buyup insurance—provides protection against more typical smaller losses of crops in exchange for a premium paid by the farmer. FCIC conducts the program primarily through private insurance companies that sell and service federal crop insurance—both catastrophic and buyup—for the federal government and retain a portion of the insurance risk. FCIC pays the companies a fee, called an administrative expense reimbursement, that is intended to reimburse the companies for the reasonable expenses associated with selling and servicing crop insurance to farmers. The reimbursement is calculated as a percentage of the premiums paid, regardless of the expenses incurred by the companies. In addition, the companies earn profits when insurance premiums exceed losses. FCIC also offers catastrophic insurance through the local offices of USDA's Farm Service Agency.

Concerned about the cost-effective delivery of federal crop insurance and recognizing the important role the private insurance industry plays in delivering federal crop insurance, the Congress, in the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, directed GAO and FCIC to jointly evaluate the financial arrangements between FCIC and insurance providers for delivering crop insurance to producers. Separately, USDA's Risk Management Agency will report on the adequacy of return on capital to insurance companies and alternative reinsurance arrangements between the government and the companies. In this report, GAO addresses (1) the adequacy of the current administrative reimbursement rate for expenses of participating crop insurance companies, (2) the comparative cost to the government in 1995 of private companies' and USDA's delivery of catastrophic insurance, and (3) the advantages and disadvantages of different expense reimbursement alternatives. Appendix I provides descriptive information on FCIC's efforts to simplify program administration.

Background

Federal crop insurance began on an experimental basis in 1938, after private insurance companies were unable to establish a financially viable crop insurance business. In 1980, the Congress enacted legislation that expanded the program and, for the first time, enlisted private insurance companies to sell, service, and share in the risk of federal crop insurance policies. Under a standard reinsurance agreement that identifies the terms and conditions for selling federal crop insurance, FCIC pays the insurance companies an administrative fee. This fee is a preestablished percentage of premiums to reimburse the companies for the expenses of selling and servicing crop insurance policies, including the expenses associated with adjusting claims. While the reimbursement rate is intended to be set at a level sufficient to cover the companies' costs of selling and servicing crop insurance policies, under the current reimbursement arrangement, the companies have no obligation to spend their payment on expenses related to crop insurance; they can spend the payment in any way they choose.

For buyup crop insurance, the administrative expense reimbursement has declined from a base rate of 34 percent of the premiums on policies sold from 1988 through 1991 to 31 percent of the premiums sold from 1994 through 1996. Prior to 1994, the reimbursement rate for administrative expenses changed as a result of negotiations between FCIC and the participating companies and budget concerns, but it was not based on actual expenditure data. The 1994 reform act requires FCIC to reduce the reimbursement rate to no more than 29 percent of total premiums in 1997, no more than 28 percent in 1998, and no more than 27.5 percent in 1999. FCIC can set the rate lower than these mandated ceilings.

While this reduction in the reimbursement rate was mandated by the act, the established rates were not based on a systematic evaluation of the costs associated with selling and servicing crop insurance. Nor have participating insurance companies been limited in how they spend their administrative expense reimbursement. Moreover, all companies did not report detailed expense information for selling and servicing crop insurance in a consistent format until 1994, when USDA began requiring companies to report data on actual expenses in order to help establish a future reimbursement rate that more clearly reflects actual expenses. Currently, FCIC is developing a new standard reinsurance agreement, including new expense reimbursement rates, that will be completed with the companies in June 1997.

In addition to receiving an administrative expense reimbursement, the insurance companies share underwriting risk with FCIC and can earn or

lose money according to the claims they must pay farmers for crop losses. Companies earn money when the premiums exceed the crop loss claims paid for those policies on which the companies retain risk. They lose money when the claims paid for crop losses exceed the premiums paid for the policies that the companies retained. Since 1990, the companies participating in this program have collectively earned \$528 million in underwriting gains.

The 1994 reform act required farmers who had not previously purchased crop insurance to purchase at least catastrophic insurance coverage if they wanted to participate in federal farm programs. (The Federal Agriculture Improvement and Reform Act of 1996 rescinded this requirement provided that farmers waive any rights to any possible disaster assistance.) Catastrophic insurance was designed to eliminate the need for expensive crop disaster assistance programs. Farmers could purchase catastrophic coverage either from the local office of USDA's Farm Service Agency or from a local insurance agent representing a participating insurance company. The cost to the farmer is a \$50 per crop processing fee whether the farmer purchases coverage through USDA or a private insurer. In 1995, participating companies were compensated with a base reimbursement rate for administrative expenses of about 14 percent of catastrophic premiums, in addition to the \$50 processing fee paid by farmers. The 1994 reform act authorized the companies to keep the fees they collected from farmers up to certain limits.

FCIC had agreements with 22 companies in 1994 and 19 companies in 1995 to sell and service federal crop insurance. In 1995, the insurance companies sold about 80 percent of all federal crop insurance, while USDA's Farm Service Agency sold the remainder. In performing its review, GAO examined expenses at nine companies representing about 85 percent of the total federal crop insurance premiums written by private companies in 1994 and 1995. Companies were selected considering factors such as premium volume, location, and type of ownership.

Results in Brief

In 1994 and 1995, the government's administrative expense reimbursement to insurance companies was greater than the companies' expenses to sell and service federal crop insurance. For the 2-year period, companies reported expenses that were less than the reimbursements paid to them by FCIC. Furthermore, GAO found that some of these reported expenses did not appear to be reasonably associated with the sale and service of federal

crop insurance and accordingly should not be considered in determining an appropriate future reimbursement rate for administrative expenses.

Among these expenses were those associated with acquiring competitors' businesses, profit-sharing bonuses, and lobbying. In addition, even within the expense categories reasonably associated with the sale and service of crop insurance, GAO found expenses that appeared excessive for reimbursement under a taxpayer-supported program suggesting an opportunity to further reduce future reimbursement rates. These expenses included agents' commissions that exceeded the industry average, unnecessary travel-related expenses, and questionable entertainment activities. Finally, higher premiums in the crop insurance program have had the effect of increasing the government's reimbursement to companies from the time period GAO examined. At the same time, companies' expenses associated with crop insurance sales and service could decrease as FCIC reduces the administrative requirements with which the companies must comply. Combined, all these factors indicate that FCIC could lower the reimbursement rate and still amply cover companies' reasonable expenses for selling and servicing federal crop insurance policies.

In 1995, the government's costs to deliver catastrophic insurance were higher through private companies than through USDA. Although the basic costs associated with selling and servicing catastrophic crop insurance through USDA and private companies were comparable, delivery through USDA avoids paying an underwriting gain to companies in years when there is a low incidence of catastrophic loss claims. In 1995, the underwriting gain to participating companies for catastrophic insurance totaled about \$45 million. In 1996, the underwriting gains were even higher.

GAO identified a number of different approaches to reimbursing companies for their administrative expenses that offer the opportunity for cost savings. Each has advantages and disadvantages compared with the existing reimbursement arrangement. Companies generally prefer the existing reimbursement method because it is relatively simple to administer.

Principal Findings

Current Reimbursements Exceed Delivery Expenses

In 1994 and 1995, FCIC's administrative expense reimbursements to the participating companies selling buyup insurance—31 percent of

premiums—were much higher than the expenses that can be reasonably associated with the sale and service of federal crop insurance. For the 2-year period, the nine companies GAO reviewed reported \$542.3 million in expenses, compared with a reimbursement of \$580.2 million—a difference of about \$38 million. In addition, GAO’s review of the companies’ reported expenses showed that about \$43 million could not be reasonably associated with the sale and service of federal crop insurance to farmers. Therefore, these expenses should not be considered in determining an appropriate future reimbursement rate for administrative expenses. These expenses included payments to compensate executives of an acquired company to refrain from joining or starting competing companies, fees paid to other insurance companies to protect against underwriting losses, bonuses tied to company profitability, management fees assessed by parent companies with no identifiable benefit to subsidiary crop insurance companies, and lobbying expenses. Adjusting for these expenses, GAO determined, and FCIC concurred, that the expense reimbursement rate for companies’ expenses reasonably associated with the sale and service of crop insurance in 1994-95 was about 27 percent of premiums. Similarly, for 1995, GAO found that the compensation to companies selling catastrophic insurance—including farmer-paid processing fees—exceeded companies’ calculated expenses for those policies by about 2 percent of catastrophic premiums.

In addition, GAO found a number of expenses reported by the companies that, while in categories associated with the sale and service of crop insurance, seemed to be excessive under a taxpayer-supported program. These expenses included above-average commissions paid to agents by one large company, corporate aircraft and excessive automobile charges, country club memberships, and various entertainment activities for agents and employees, such as sky box rentals at professional sporting events and company-sponsored fishing trips. While difficult to fully quantify, these types of expenditures suggest that opportunities exist for the government to reduce its future reimbursement rate for administrative expenses while still adequately reimbursing companies for the reasonable expenses of selling and servicing crop insurance policies.

Furthermore, a variety of factors that have emerged since the period covered by GAO’s review have increased companies’ revenues or may decrease companies’ expenses. Crop prices and premium rates increased in 1996 and 1997, thereby generating higher premiums, which had the effect of increasing the reimbursements paid to companies for administrative expenses by about 3 percent of premiums. FCIC’s efforts to

simplify the program's administrative requirements may reduce companies' workload, thereby reducing their administrative expenses.

Government's Cost to Deliver Catastrophic Insurance Through USDA Is Less Than Through Private Companies

In 1995, the government's costs to deliver catastrophic insurance policies were higher through private companies than through USDA. The basic cost to the government for selling and servicing crop insurance was comparable for both delivery systems. However, when private companies delivered the insurance, they received an estimated \$45 million underwriting gain that did not apply to USDA's delivery. Underwriting gains are not guaranteed and vary annually, depending on crop losses. According to FCIC, the underwriting gain in 1995 totaled 37 percent of those catastrophic premiums for which the companies retained risk. This 1-year underwriting gain substantially exceeded FCIC's long-term target, which in 1995 was 7 percent of the companies' retained premiums. In 1996, the underwriting gain was even higher—about \$58 million. Beginning with crops harvested in 1997, the Federal Agriculture Improvement and Reform Act of 1996 requires that USDA phase out its delivery of catastrophic crop insurance in areas that have sufficient private company providers. In July 1996, the Secretary of Agriculture identified 14 states where sufficient commercial delivery was available and USDA would no longer sell and service catastrophic insurance.

Alternative Reimbursement Arrangements Offer Potential for Savings

The current arrangement for reimbursing companies for their administrative expenses, under which FCIC pays private companies a fixed percentage of premiums, has certain advantages, including ease of administration. However, expense reimbursements based on a percentage of premiums do not necessarily reflect the amount of work involved to sell and service crop insurance policies. Alternative reimbursement arrangements, such as (1) capping the reimbursement per policy, (2) paying a flat dollar amount per policy plus a reduced fixed percentage of premiums, and (3) paying a declining reimbursement rate as companies' premium volume increases, offer the potential to have reimbursements more reasonably reflect expenses. Some alternatives may also help smaller companies compete more effectively with larger companies and/or encourage more service to smaller farmers than does the current system. While some of the alternative reimbursement methods may result in lower cost reimbursements to insurance companies, some methods may increase FCIC's own administrative expenses for reporting and compliance. Companies generally prefer FCIC's current reimbursement method because of its administrative simplicity. FCIC has included the second

alternative—paying a flat dollar amount per policy plus a fixed percentage of premiums—in its proposed 1998 standard reinsurance agreement with the industry.

Recommendations to the Secretary of Agriculture

GAO's review shows that the 1994 and 1995 administrative reimbursement rate for buyup crop insurance—31 percent of premiums—was higher than the companies' expenses reasonably associated with selling and servicing crop insurance for the 2-year period which GAO calculated at about 27 percent of premiums. According to GAO's analysis, if crop prices and premium rates remain at 1996-97 levels, FCIC could reduce its reimbursement rate 3 percentage points below this 27-percent rate, and companies could still be adequately reimbursed for their reasonable expenses of selling and servicing crop insurance. GAO's review also shows that in 1995 the compensation to companies for catastrophic insurance was higher than the companies' expenses associated with selling and servicing this insurance. Finally, an analysis of the government's 1995 costs to deliver catastrophic insurance through private companies and through USDA shows that basic delivery expenses are comparable for the two delivery systems but that underwriting gains to companies made private delivery more expensive. Companies' underwriting gains to date substantially exceed FCIC's target.

Accordingly, to better ensure that the reimbursement rate to participating companies more closely reflects their actual expenses for delivering crop insurance, GAO recommends that the Secretary of Agriculture direct the Administrator of the Risk Management Agency to

- determine a reimbursement rate for administrative expenses that reflects the appropriate and reasonable costs of selling and servicing buyup insurance and include this rate in the new agreement currently being developed with the companies;
- determine the compensation that reflects the appropriate and reasonable costs of selling and servicing catastrophic crop insurance and include it in the new agreement being developed with the companies;
- explicitly convey to participating insurance companies the type of expenses that the administrative reimbursement is intended to cover;
- monitor companies' expenses to ensure that the established rate is reasonable for the services provided; and
- closely monitor the experience of the catastrophic insurance program to ensure that over time the underwriting gains earned on catastrophic

insurance by the companies do not exceed FCIC's long-term target for gains.

USDA and Crop Insurance Industry Comments

GAO provided a draft of this report to the U.S. Department of Agriculture for review and comment. GAO also provided a draft of this report to National Crop Insurance Services, Inc., which was designated by the crop insurance companies included in GAO's review to respond to this report. In addition, at the request of some crop insurance companies, the American Association of Crop Insurers and the Crop Insurance Research Bureau, Inc. jointly provided comments on a draft of this report.

GAO met with USDA's Administrator for the Risk Management Agency, who agreed with the information presented in the draft report and its conclusions and recommendations. In its proposed 1998 standard reinsurance agreement with the private insurance companies, FCIC has included changes to the expense reimbursement rate for delivering both buyup and catastrophic insurance. Additionally, in this proposed agreement, FCIC has clarified the types of expenses that the administrative reimbursement is intended to cover, and it plans to monitor companies' expenses in the future as a result of GAO's review. USDA's Risk Management Agency noted that the information in this report provides a strong basis for conducting future expense audits to continue verification of private insurance companies' costs for delivering crop insurance.

The crop insurance industry disagreed with GAO's methodology, findings, conclusions, and recommendations. GAO is confident that its methodology is sound, the report's findings and conclusions are well supported, and the recommendations offer reasonable suggestions for reducing the costs of the crop insurance program.

In responding to GAO's draft report, the industry raised questions in four broad areas.

First, the industry believes that GAO failed to meet the mandate contained in the 1994 reform act because the review focused on the costs to deliver crop insurance and did not consider quality of service. GAO focused on delivery costs because in researching the legislative history of this provision, GAO found that in the context of funding this program and other agricultural programs in a deficit reduction environment, the paramount congressional interest was in controlling the costs of reimbursing crop insurers. Furthermore, GAO confirmed its interpretation of the mandate in

a commitment letter sent to the Chairmen and Ranking Minority Members of the Senate Committee on Agriculture, Nutrition, and Forestry, and the House Committee on Agriculture. This letter set forth GAO's approach for meeting this mandate including its scope and methodology. Consequently, GAO's report focuses on costs incurred by insurers that are reimbursed by the government in order to provide information most useful to congressional decisionmakers. Therefore, GAO believes that the report fulfills the mandate of the Congress. (See ch. 1.)

Second, the industry raised questions about the methodology used in the review, including the time period GAO examined; the standards GAO used to judge the allowability of expenses; and the applicability of emerging factors, such as increased premium rates and higher crop prices, to future cost reimbursements. GAO examined the costs of the crop insurance program for 1994 and 1995 to provide a picture of expenses for delivering crop insurance before and after the implementation of the 1994 reform act. Furthermore, these were the first 2 years that the industry provided the detailed data in a consistent format needed to fully analyze the expenses associated with selling and servicing crop insurance. The industry stated that GAO was understating administrative expenses by using 2 years in which crop losses were relatively low. GAO disagrees. Crop losses for buyup coverage in 1995 were equal to or higher than crop loss experiences throughout the 1990s, except for 1993. Furthermore, GAO found that high crop losses did not significantly increase companies' loss-adjusting expenses—the administrative cost component most likely to be affected by high crop losses. Moreover, since the 1980s, the companies have received additional reimbursements in years of high crop losses. The standards GAO used to identify reasonable costs for delivering crop insurance were developed on the basis of a number of different widely recognized accounting, insurance, and acquisition standards. FCIC agreed that the standards used were appropriate. Moreover, two factors that have emerged since the 1994-95 time period that GAO reviewed—higher premium rates and higher crop prices in 1996 and 1997—should be considered in evaluating the appropriate future reimbursement rate because these factors increased companies' revenues without an increase in expenses. (See ch. 2.)

Third, without offering specific details, the industry expressed concern that the implementation of GAO's recommendations would destabilize the crop insurance industry. The industry's profitability is primarily driven by the difference between premiums received and claims paid—its underwriting profits. Administrative expense reimbursements are intended

to just cover expenses. They were never intended to include a profit margin. GAO continues to believe that a reimbursement rate in the range of 24 percent will adequately compensate companies for the reasonable expenses of delivering crop insurance. This lower reimbursement rate should not diminish service to the farmer nor destabilize the program. Companies will still have the opportunity to realize underwriting profits as they have since the program began. (See ch. 2.)

Finally, the industry questioned GAO's methodology for comparing the cost to the government of the industry's and USDA's delivery of catastrophic insurance. Specifically, it stated that the processing fees paid by farmers and the underwriting gains paid to companies should not be considered in analyzing the costs to the government for catastrophic insurance delivery. GAO disagrees that an analysis of the comparative costs to the government of company- and USDA-delivered catastrophic insurance should exclude the processing fee and underwriting gains components. In computing the overall costs to the government, all revenue and payment components have to be considered. The industry's comments also indicate that it believes GAO's conclusions might mislead policymakers by implying that delivery of catastrophic insurance by private industry should be reduced. GAO does not believe that this is the case. GAO did not conclude or recommend that the industry should have its role in catastrophic insurance delivery reduced. GAO continues to hold the view, however, that the level of underwriting gain paid to the companies should be managed so that it more closely follows FCIC's targets. (See ch. 3.)

The industry's specific comments and GAO's response are presented in detail in appendixes VIII and IX.

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Abbreviations

FAR	Federal Acquisition Regulation
FCIC	Federal Crop Insurance Corporation
FSA	Farm Service Agency
NAIC	National Association of Insurance Commissioners
NCIS	National Crop Insurance Services, Inc.
USDA	U.S. Department of Agriculture

Introduction

Federal crop insurance protects participating farmers against crop losses caused by perils such as droughts, floods, hurricanes, and other natural disasters. The federal program—which began on an experimental basis in 1938 after private insurance companies were unable to establish a financially viable crop insurance business—was restructured and greatly expanded by key legislation in 1980 and 1994. A major component of the 1980 legislation was the enlistment, for the first time, of private insurance companies to sell, service, and share the risk on federal crop insurance policies. In 1994, the Congress further broadened the program by offering farmers catastrophic risk insurance. This coverage, established at a minimum level, incorporated elements of the former crop disaster assistance program into crop insurance provided jointly by the U.S. Department of Agriculture (USDA) and private insurance companies.¹

USDA's Risk Management Agency administers the federal crop insurance program through the Federal Crop Insurance Corporation (FCIC). FCIC pays the participating companies a fee, called an administrative expense reimbursement, that is intended to reimburse the companies for the reasonable expenses associated with selling and servicing crop insurance to farmers. The reimbursement is calculated as a percentage of the premiums paid, regardless of the expenses incurred by the companies. In addition to this reimbursement, participating insurance companies share with FCIC any gains or losses—known as underwriting gains and underwriting losses—that result from the insurance policies they sell. In 1994, 22 participating insurance companies received \$395 million from the program—about \$292 million in administrative expense reimbursements plus about \$103 million in underwriting gains. In 1995, 19 participating insurance companies received \$506 million from the program—about \$373 million in administrative expense reimbursements plus about \$133 million in underwriting gains. Expense reimbursements and underwriting gains varied by company according to the amount of premiums written, the amount of risk retained, and the management of the risk retained.

¹This report focuses on multiple-peril crop insurance that protects against losses of production. Since 1995, newer types of crop insurance have become available. These policies are designed to guarantee farmers a minimum level of revenue by protecting against production losses and fluctuations in crop prices.

How Federal Crop Insurance Works Under the Crop Insurance Reform Act of 1994

Federal crop insurance offers farmers two primary types of insurance coverage—catastrophic and buyup. Both types of coverage are available for most major crops under the changes made by the Congress in the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 (P.L. 103-354, Oct. 13, 1994, title I). This act created catastrophic risk insurance as a replacement for expensive crop disaster assistance. Catastrophic insurance provides farmers with protection against extreme crop losses for a small processing fee. Buyup insurance provides protection against more typical and smaller crop losses in exchange for a farmer-paid premium. Participating insurance companies offer both types of insurance, whereas USDA's Farm Service Agency (FSA), through its local offices, offers only catastrophic insurance. Under the terms of a negotiated agreement, participating insurance companies sell crop insurance and process any claims in exchange for an administrative expense reimbursement and for the opportunity to share in the potential for underwriting gains. The government pays the total premium for catastrophic insurance and a portion of the premium for buyup insurance. FCIC establishes the premiums, terms and conditions for both types of insurance.

Under the 1994 reform act, farmers who had not previously purchased crop insurance were required to purchase at least catastrophic insurance coverage if they signed up for USDA's annual commodity programs; obtained USDA's farm ownership, operating, or emergency loans; or contracted to place land in the Conservation Reserve Program. Subsequently, the Federal Agriculture Improvement and Reform Act of 1996 (P.L. 104-127, Apr. 4, 1996) eliminated this mandatory linkage by permitting farmers, effective for crops harvested in 1996, to forgo crop insurance for any given crop without losing eligibility for other programs, provided they waive all rights to any possible crop disaster assistance in connection with the particular crop.

Catastrophic insurance, which protects farmers against extreme losses, is often referred to as minimum coverage because it provides protection at the lowest production and price levels offered. Catastrophic insurance pays farmers only when they experience production losses greater than 50 percent of their normal crop. A normal crop is determined on the basis of a farmer's production history as reported to USDA's local office or to the insurance agent. For production losses greater than 50 percent, farmers are paid 60 percent of FCIC's projected market price for the crop.

Farmers desiring protection above the minimum price or production levels provided by catastrophic insurance can purchase buyup insurance. Unlike farmers who purchase catastrophic insurance, farmers purchasing buyup insurance must choose both the coverage level (the proportion of the crop to be insured) and the unit price (e.g., per bushel) at which any loss is calculated. With respect to the coverage level, farmers can choose to insure as much as 75 percent of normal production (25-percent deductible) or as little as 50 percent of normal production (50-percent deductible) at different price levels. With respect to unit price, farmers choose whether to value their insured production at FCIC's full projected market price or at a percentage of the full price. FCIC adjusts farmers' premiums according to the production and price levels selected.

The following example illustrates how a claim payment is determined under catastrophic insurance, which insures 50 percent of production and 60 percent of the price. A farmer whose normal crop production averages 100 bushels of corn per acre and who chooses catastrophic insurance will be guaranteed 50 percent of 100 bushels, or 50 bushels per acre. Assuming that FCIC had estimated the market price for corn at \$3 per bushel, the farmer will be guaranteed a price of 60 percent of \$3, or \$1.80 per bushel. The farmer's total coverage per acre will be \$90 (50 bushels x \$1.80 per bushel). This total amount will be paid in the event of a complete crop failure. Should an event like drought cut the farmer's actual harvest from 100 to 60 bushels, the farmer will not receive a payment because, in this example, catastrophic insurance only pays if the yield drops below 50 bushels per acre. If a more severe problem caused the yield to fall to 25 bushels per acre, the farmer will be paid for the loss of 25 bushels per acre—the difference between the insured production level of 50 bushels and the actual production of 25 bushels. In this case, catastrophic insurance will pay the farmer's claim at \$1.80 x 25 bushels, or \$45 per acre.

If this same farmer chooses buyup insurance at the 75-percent coverage level, the farmer will be guaranteed 75 percent of 100 bushels, or 75 bushels per acre. Assuming that the farmer had chosen the maximum price coverage of 100 percent, and that FCIC had estimated the market price for corn at \$3 per bushel, the farmer's price coverage will be \$3 per bushel. Accordingly, the farmer will have coverage in the event of a total crop loss of \$225 per acre (75 bushels x \$3 per bushel). Should drought or other perils cut the farmer's actual harvest to 60 bushels, the farmer will be paid for the loss of 15 bushels per acre—the difference between the insured production level of 75 bushels and the actual production of 60 bushels. In this case, buyup insurance will pay the farmer's claim at \$3 x 15 bushels,

or \$45 per acre. In the event of a more severe loss that reduced production to a level of 25 bushels per acre, the farmer will be paid for the loss of 50 bushels per acre—the difference between the insured production level of 75 bushels and the actual production of 25 bushels. In this case, buyup insurance will pay the farmer's claim at \$3 x 50 bushels, or \$150 per acre.

The Insurance Companies' Role in Crop Insurance Delivery

According to a written agreement between FCIC and participating insurance companies—called the standard reinsurance agreement—FCIC pays the participating companies a uniform reimbursement for administrative expenses at a preestablished percentage of total premiums to deliver—sell and service—catastrophic and buyup insurance. This base rate can be, and has been, supplemented to provide additional funding in years when administrative costs were high because of excess losses or when other factors require the companies to conduct additional work. Beginning in 1994, as part of the agreement, FCIC required each participating company to report its delivery expenses to FCIC for the prior year to help determine the long-term adequacy of the reimbursement rate. In addition to providing an administrative expense reimbursement, this agreement governs the participating companies' share of any underwriting gains or losses resulting from the policies they sell.

FCIC does not directly reimburse the participating companies for their actual costs of administering the program. Instead, FCIC pays all participating companies a uniform administrative expense reimbursement at a preestablished percentage of total premiums (including the farmer-paid premium, government premium subsidy² for buyup insurance, and the imputed premium³ for catastrophic insurance). FCIC pays participating companies an administrative expense reimbursement that is intended to reimburse them for the expenses that can be reasonably associated with the sale and service of federal crop insurance, including the expenses associated with adjusting claims. Because the reimbursement is not tied to specific expenses, the companies are not obligated to spend the payment they receive on selling or servicing crop insurance policies; the payments can be used in any way the companies choose. Since 1980, in fact, the reimbursement rate has evolved as a result of negotiations between FCIC and the participating companies and budget

²FCIC pays a portion of the premium. The amount of the subsidy varies depending on the level of coverage selected, averaging about 40 percent of the premium.

³Farmers are not required to pay any premium for catastrophic insurance. However, for purposes of computing the administrative reimbursement, FCIC credits the companies with sales based on the total premiums that would otherwise apply for this level of insurance.

concerns and has not been based on a systematic evaluation of companies' expenses.

For buyup insurance, the administrative expense reimbursement base rate under the standard reinsurance agreement has declined from a high of 34 percent of total premiums between 1988 and 1991 to 31 percent between 1994 and 1996. In 1995, the administrative expense reimbursement for buyup insurance totaled 32.6 percent of buyup premiums. This reimbursement rate included a base administrative expense reimbursement of 31.0 percent of premiums and a supplemental reimbursement of 1.6 percent of premiums associated with extra adjustments for crop losses in 1995. The 1994 reform act requires FCIC to limit the reimbursement rate for selling and servicing buyup insurance to no more than 29 percent of total premiums in 1997, no more than 28 percent in 1998, and no more than 27.5 percent by 1999. While this reduction in reimbursement rate was mandated by the act, the established rates were not based on a systematic evaluation of the costs associated with selling and servicing crop insurance.

For catastrophic insurance, companies were paid a lower base reimbursement rate—13.8 percent of the imputed premiums—for delivering catastrophic insurance and were allowed to keep most of the \$50 processing fee paid by farmers. In 1995, compensation for catastrophic insurance totaled 24.0 percent of catastrophic premiums, including (1) a base administrative expense reimbursement of 13.8 percent of premiums;⁴ (2) a retained farmer-paid processing fee of \$50, equating to 9.3 percent of premiums; and (3) a supplemental reimbursement of 0.9 percent of premiums associated with extra adjustments for crop losses in 1995.

Beginning in 1994, FCIC began to require companies to submit a detailed expense report in a consistent format following standard industry guidelines for the prior calendar year—1993. However, not all companies complied with the new requirement until 1995 when they reported 1994 expense data. This expense reporting has to comply with a number of guidelines, such as those that the National Association of Insurance Commissioners issues on allocating expenses among lines of business. These expense reports do not directly affect the amount paid to the companies but rather provide support and serve as an indicator for establishing future reimbursement rates for administrative expenses. Included in the expenses reported are loss adjustment costs, sales

⁴This equates to 4.7 percent of premiums calculated at the buyup level of 65 percent coverage and 100 percent projected market price.

commissions paid to local insurance agents, and the general administrative expenses associated with operating the insurance companies, such as payroll, equipment, travel, training, and rent. Currently, FCIC is developing a new standard reinsurance agreement, including new expense reimbursement rates, that will be completed with the participating companies in June 1997.

In addition to receiving an administrative expense reimbursement, the participating companies share any underwriting gains or losses with FCIC that result from the policies the companies sell. Underwriting gains occur if the premiums exceed the claims paid on the policies. In the same manner, underwriting losses occur when the claims paid exceed the premiums. The participating companies are able to vary the extent to which they share in the risk. In general, the companies choose to retain more of the risk on the historically lower-loss producers and share more of the risk with FCIC for those producers who have a history of more frequent or more severe loss experience. In addition, to protect participating companies against high underwriting losses in years with extreme crop losses, FCIC limits the total loss that participating companies must share.

The number of companies selling and servicing crop insurance for FCIC has decreased from 27 in 1990 to 16 in 1996 because of business acquisitions and changing business relations. Insurance premiums written by participating companies during this same period increased from \$747 million in 1990 to \$1.6 billion in 1996. As shown in table 1.1, FCIC paid participating companies significantly larger administrative expense reimbursements than the companies earned in underwriting gains between 1990 and 1996. This reflects the fact that the reimbursement is a fixed fee based on premiums written, whereas the underwriting gain varies depending on crop loss experiences.

Table 1.1: Participating Companies' Gains, Losses, and Administrative Expense Reimbursements, 1990-96

Dollars in millions

Year	Underwriting gain (loss)	Administrative expense reimbursement	Total
1990	\$52	\$272	\$324
1991	42	245	287
1992	22	246	268
1993	(82)	250	168
1994	103	292	395
1995	133	373	506
1996 (estimate)	258	490	748
Total	\$528	\$2,168	\$2,696

Source: FCIC.

Recent Federal Crop Insurance Sales

Between 1994 and 1995, federal crop insurance sales increased from \$918 million to over \$1.5 billion. In 1995, catastrophic insurance accounted for \$456 million in premiums, and buyup insurance accounted for an additional \$1.1 billion in premiums. Before catastrophic insurance was available, the program had been generating average premiums of about \$700 million a year. As shown in table 1.2, participating companies sold a larger portion of federal crop insurance than USDA.

Table 1.2: Total Crop Insurance Premiums Sold by Companies and USDA by Type, 1994-95

Dollars in millions

Insurance type	1994			1995			1996		
	Companies	USDA	Total	Companies	USDA	Total	Companies	USDA	Total
Catastrophic	\$0	\$0	\$0	\$175	\$281	\$456	\$215	\$209	\$424
Buyup	\$918	\$0	\$918	\$1,086	\$0	\$1,086	\$1,397	\$0	\$1,397
Total	\$918	\$0	\$918	\$1,261	\$281	\$1,543	\$1,612	\$209	\$1,821
Market share	100%	0%	100%	82%	18%	100%	89%	11%	100%

Source: FCIC.

In 1996, federal catastrophic crop insurance sales decreased slightly to \$424 million, while federal buyup insurance increased to almost \$1.4 billion.

Government Costs Have Increased in Recent Years

Under the expanded federal crop insurance program created by the 1994 reform act, program costs increased from over \$700 million in the early 1990s to about \$1.6 billion in 1996.⁵ As shown in table 1.3, federal crop insurance costs paid by the government totaled about \$7.2 billion from 1990 through 1996 and were made up of claims paid in excess of premiums (\$1.6 billion), premium subsidy (\$2.8 billion), administrative expense reimbursements (\$2.2 billion), and other administrative costs (\$611 million).

Table 1.3: Government Cost of Federal Crop Insurance

Dollars in millions

Fiscal year	Claims paid in excess of premiums and other income	Premium subsidy	Administrative expense reimbursements	Other administrative costs	Total government cost
1990	\$233	\$213	\$272	\$87	\$805
1991	247	196	245	84	772
1992	232	197	246	88	763
1993	751	198	250	105	1,304
1994	(127)	247	292	78	490
1995	188	774	373	105	1,440
1996 (estimated)	88	978	490	64	1,620
Total	\$1,612	\$2,803	\$2,168	\$611	\$7,194

Source: FCIC.

Objectives, Scope, and Methodology

Concerned about the cost-effective delivery of federal crop insurance and recognizing the important role the private insurance industry plays in delivering federal crop insurance, the Congress, in section 118 of the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, directed GAO and FCIC to jointly evaluate the financial arrangements between FCIC and participating insurance companies for delivering the crop insurance program to qualified producers and to address several specific issues. Separately, USDA's Risk Management Agency will report on the adequacy of return on capital to insurance companies and alternative reinsurance arrangements between the government and the companies. Our review focused on the following two issues:

⁵For 1990 through 1993, crop disaster assistance averaged \$1.1 billion annually.

- The adequacy and reasonableness of the current administrative reimbursement rate for expenses of participating companies; and
- The cost to the government of private-sector delivery compared with USDA delivery of catastrophic insurance.

As required by the act, we also reviewed and reported on (1) the advantages and disadvantages of alternatives to the current arrangement for reimbursing administrative expenses, and (2) FCIC's actions to simplify procedural and administrative requirements. The results of our work for these two topics are reported in chapter 4 and appendix I, respectively.

To assess the adequacy of the current reimbursement rate for administrative expenses, we compared participating companies' reported expenses for selling and servicing buyup insurance with reimbursements they received from FCIC for 1994 and 1995. Not all participating companies reported these expenses to FCIC in a consistent format until 1994; furthermore, 1996 expenses for selling and servicing crop insurance were not complete at the time of our review. We assessed expense data for crop insurance at nine participating companies that represented about 80 and 85 percent of the crop insurance premiums in 1994 and 1995, respectively. To gain an understanding of crop insurance expenditures, we interviewed representatives from participating companies and obtained an explanation of all reported expenses. In addition, to evaluate the reasonableness of reported expenses, we used as guidance FCIC's listing of allowable expenses, the National Association of Insurance Commissioners' guidelines, generally accepted accounting principles, federal acquisition regulations, and the Internal Revenue Code.

Within the framework of these standards and guidelines, we made judgments about what we considered to be reasonably associated expenses for selling, processing, and adjusting crop insurance policies for the federal government and discussed these judgments with the FCIC officials responsible for administering the program. Generally, we considered as reasonable those expenses associated with (1) interacting with farmers, (2) reviewing insured property, (3) processing policy and claims paperwork, and (4) related overhead and indirect costs, including the training and travel of staff. As part of our review, we examined participating companies' complete list of reported expenses. For a judgmental sample of these reported expenses, we traced the expenses to source documents. Our results reflect only the findings at the companies we reviewed and do not necessarily reflect the conditions for other companies selling federal crop insurance. We did not specifically validate

companies' accounting systems, but we did review each company's audited financial statements to ensure ourselves that the financial data provided were reasonable. Appendix II provides a list of the participating companies we visited.

To examine the cost differences to the government between USDA and private-sector delivery of catastrophic insurance, we analyzed the government's costs to use participating companies in comparison with the costs of using USDA. To perform our analysis, we obtained 1995 data on the costs to deliver catastrophic insurance through USDA, including costs for USDA's headquarters in Washington D.C.; its main field offices in Kansas City, Missouri; and its state, regional service, district, and local offices. We reduced the costs for USDA's delivery system by the amount of processing fees the Department collected from farmers for catastrophic insurance. We made the reduction because USDA uses these fees to reduce other government expenditures. To identify the government's costs to use participating companies to deliver catastrophic insurance, we obtained data from FCIC on administrative expense reimbursements as well as underwriting gains paid to companies that participated in the catastrophic insurance program in 1995.

To identify alternative methods for expense reimbursements, we interviewed officials of selected participating companies, trade associations, and USDA. We then narrowed the compilation down to four distinct alternatives and analyzed them against the 1995 crop insurance experience, where reasonable, to measure their impact as if they had been in place for that year. We also determined qualitative factors associated with each of the methods through discussions with industry and FCIC officials.

To determine the status of procedural and administrative simplification, we reviewed FCIC's summary of completed and in-progress simplification and paperwork reduction actions; and we reviewed potential simplification actions proposed by FCIC and by representatives of the crop insurance industry. We discussed the potential cost and benefit of these proposed actions with crop insurance company and FCIC officials. The information we developed is presented in appendix I.

We conducted our review from March 1996 through March 1997 in accordance with generally accepted government auditing standards. Although we did not independently assess the accuracy and reliability of

USDA's computerized databases, we used the same files USDA uses to manage the crop insurance program and its local county offices.

In December 1996, we provided USDA officials and representatives of National Crop Insurance Services, Inc., the American Association of Crop Insurers, the Crop Insurance Research Bureau, Inc., and several individual companies with a detailed briefing on the results of our review. In March 1997, we provided a copy of our draft report to USDA and to the crop insurance industry organizations for their review and comment. The Department's and industry's comments are addressed at the end of each chapter. In addition, the industry's written comments are reproduced in appendixes VIII and IX.

USDA and Crop Insurance Industry Comments

USDA's Risk Management Agency found no fault with our methodology. However, the industry associations that received copies of our draft report stated that our review did not fully respond to the Congress' mandate in the 1994 reform act because we focused on delivery costs and did not address other requirements of the act. We focused on delivery costs because, in researching the legislative history of this mandate, we found that in the context of funding this program in a deficit reduction environment, the paramount congressional interest was in controlling the costs of reimbursing crop insurers. Furthermore, we confirmed our interpretation of the mandate in a commitment letter sent to the Chairmen and Ranking Minority Members of the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agriculture. This letter set forth our approach for meeting this mandate including our scope and methodology. Consequently, we focused on costs incurred by insurers that are reimbursed by the government in order to provide the information most useful to congressional decisionmakers. Therefore, we believe that the report fulfills the Congress' mandate.

Administrative Expense Reimbursements Paid by the Government Exceed Private Companies' Expenses

In 1994 and 1995, FCIC's reimbursement payments to the nine participating companies in our review were higher than the expenses that can be reasonably associated with the sale and service of federal crop insurance. For the 2-year period, the companies we reviewed reported \$542.3 million in expenses, compared with a reimbursement of \$580.2 million—a difference of about \$38 million. In addition, our review of the companies' reported expenses showed that about \$43 million did not appear to be reasonably associated with the sale and service of federal crop insurance to farmers and thus, should not be considered in determining future administrative reimbursement rates. These expenses included payments to compensate company executives for refraining from joining or starting competing companies, fees paid to other insurance companies to protect against underwriting loss, bonuses tied to company profitability, management fees paid to parent companies with no identifiable benefit to subsidiary crop insurance companies, and lobbying expenses.

We further identified a number of expenses reported by the companies that, while in categories that can be reasonably associated with the sale and service of crop insurance, seemed to be excessive for a taxpayer-supported program. These expenses included above-average commissions paid to agents by one large company, corporate aircraft and excessive automobile charges, country club memberships, and various entertainment activities for agents and employees, such as stadium sky box rentals at professional sporting events and company-sponsored fishing trips. Although nothing in the current agreement between FCIC and the insurance companies precludes the companies from spending on these items, we believe that these types of expenses suggest that opportunities exist for the government to reduce its future reimbursement rate. Furthermore, a variety of emerging factors, including higher crop prices and higher premium rates in 1996 and 1997, and program simplification, have increased companies' revenues or may decrease companies' expenses.

Reimbursements Exceed Expenses

For 1994 and 1995, companies collectively reported expenses that were less than the administrative expense reimbursement they received from FCIC. For 1994, the reimbursement was equal to the expenses reported, and for 1995, reported expenses were about \$38 million less than the reimbursement. After examining the companies' expense reports, however, we determined that a number of the reported expenses did not appear to be reasonably associated with the sale and service of crop insurance to farmers and thus, should not be considered in determining an

appropriate future reimbursement rate for administrative expenses. After adjusting the expense reports to delete these items, we found that the expenses reasonably associated with crop insurance delivery were about \$43 million less than those reported.

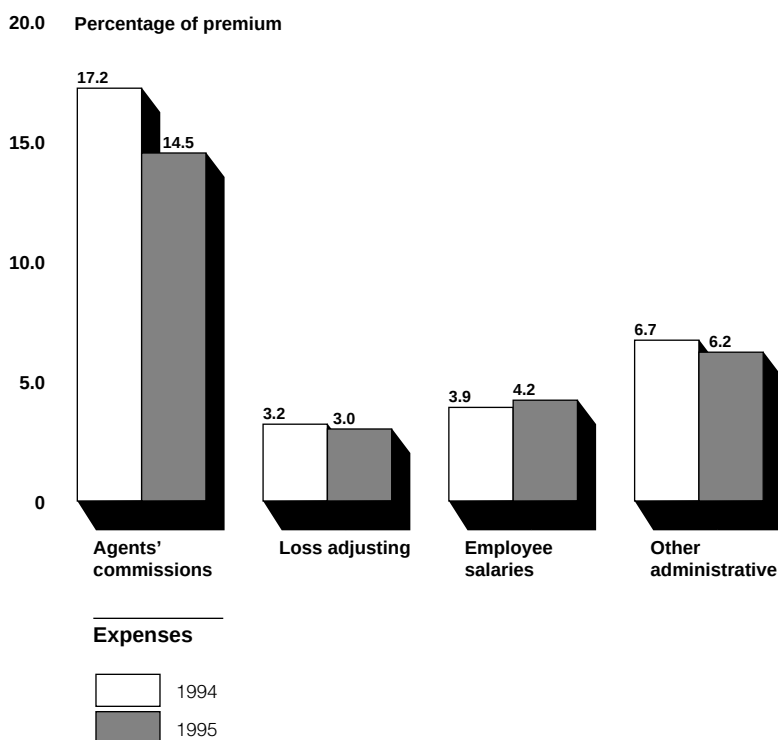
**Companies Received
Higher Reimbursements
Than Their Expenses Over
2-Year Period**

In total for 1994 and 1995, the nine companies we reviewed reported expenses for buyup and catastrophic crop insurance sales and service that were somewhat less than the administrative expense reimbursement FCIC paid them. FCIC administrative expense reimbursements paid to participating companies in 1994 and 1995 were 31 and 31.4 percent of total premiums,¹ respectively. This represented \$236.5 million in 1994 and \$343.6 million in 1995. For these same years, the companies reported expenses of 31 percent, or \$236.8 million, and 27.9 percent, or \$305.5 million, respectively. Collectively, reported expenses were \$38 million less than the reimbursements the companies received.

As shown in figure 2.1, the largest component of the expenses reported by the companies went to pay sales commissions to local insurance agents.

¹In this context, total premiums include the farmer-paid premium as well as the government-paid premium subsidy. For catastrophic coverage, the entire premium amount is subsidized by the government.

Figure 2.1: Reported Crop Insurance Delivery Expenses, 1994 and 1995, Nine Participating Companies



Source: GAO's analysis of nine participating companies' data.

The average commission reported for 1995 was less than in 1994—14.5 percent of total premiums compared with 17.2 percent of total premiums in 1994. The 1995 average commission was lower because in that year companies combined catastrophic expenses, which have lower agent commissions, with buyup expenses. With respect to loss-adjusting expenses, although insurance claims were higher in 1995 than in 1994, the company reports that showed average loss-adjusting expenses as a percent of premium actually dropped slightly in 1995.

Some Reported Expenses Do Not Appear to Be Reasonably Associated With Crop Insurance Delivery

Our review of the nine companies' reported expenses showed that about \$43 million did not appear to be reasonably associated with the sale and service of federal crop insurance to farmers and thus should not be considered in determining an appropriate future reimbursement rate for administrative expenses. Expenses reported by the companies that did not appear to contribute to the sale and service of crop insurance were expenses related to

- acquiring competitors' businesses,
- protecting companies from underwriting losses,
- sharing profits through bonuses or management fees,
- lobbying, and
- reporting errors and omissions.

Each of these types of expenses is discussed below.

Expenses Related to Acquisition of Competitors' Businesses

Among the reported costs that did not appear to be reasonably associated with the sale and service of crop insurance to farmers were those related to costs the companies incurred when they acquired competitors' business. These costs potentially aided the companies in vying for market share and meant that one larger company, rather than several smaller companies, was delivering crop insurance to farmers. However, this consolidation was not required for the sale and service of crop insurance to farmers, provided no net value to the crop insurance program, and according to FCIC, was not an expense that FCIC expected its reimbursement to cover.

We identified costs in this general category totaling \$12 million—\$8.3 million in 1994 and \$3.7 million in 1995. For example, one company took over the business of a competing company under a lease arrangement. The lease payment totaled \$3 million in both 1994 and 1995. About \$400,000 of this payment could be attributed to actual physical assets the company was leasing and we recognized this amount as a reasonable expense. However, the remaining \$2.6 million—which the company was paying each year for access to the former competitor's policyholder base—provided no benefit to the farmer and added no net value to the program. Likewise, we saw no apparent benefit to the crop insurance program from the \$1.5 million the company paid executives of the acquired company over the 2-year period as compensation for not competing in the industry.

In a related instance, the company reported a \$3.9 million expense to write down the value of an acquired company because of liabilities identified after acquiring that company's business. These liabilities arose from crop insurance claims in dispute, crop insurance claims paid in error, premium adjustments, legal actions, and bad debts relating to the acquired company's operations in prior years. This expense reflected a cost that the company incurred to increase its market share and provided no net benefit to the program. Although FCIC did not explicitly refer to this type of expense in its last standard reinsurance agreement with companies, we discussed this type of expense with FCIC. It agreed that this expense cannot be reasonably associated with the sale and service of crop insurance and thus should not be considered in determining a future reimbursement rate for administrative expenses.

Expenses Related to Protecting
the Companies From
Underwriting Losses

We also found that two companies included payments to commercial reinsurers among their reported delivery expenses for crop insurance. These are payments the companies made to other insurance companies to expand their protection against potential underwriting losses. This commercial reinsurance allows companies to expand the amount of insurance they are permitted to sell under insurance regulations while limiting their underwriting losses. The cost of reinsurance relates to companies' decisions to manage underwriting risks rather than to the sale and service of crop insurance to farmers. Although FCIC did not explicitly refer to this type of expense in its last standard reinsurance agreement with companies, we discussed this type of expense with FCIC. It agreed that this expense should be paid from company underwriting results and thus should not be considered in determining a future reimbursement rate for administrative expenses. For the two companies that reported reinsurance costs as an administrative expense, these expenses totaled \$10.7 million over the 2 years—\$5.4 million in 1994 and \$5.3 million in 1995.

Expenses Resulting From
Sharing Profits Through
Bonuses or Management Fees

Among their reported administrative expenses for crop insurance, some companies included expenses resulting from decisions to share profits with (1) company executives and employees through bonuses or (2) parent companies through management fees. We found that expenditures in this general category totaled \$12.2 million—\$5 million in 1994 and \$7.2 million in 1995. We do not believe that bonuses associated with profit sharing are appropriate for inclusion in a long-term reimbursement rate. In contrast, we believe that bonuses given to recognize employee performance, as well as bonuses paid to agents, are reasonable expenses associated with the sale and service of crop insurance, and we included them as reasonable expenses.

Profit-sharing bonuses—bonuses linked to overall company profitability for each year—were a significant component of total salary expenses at one company, equaling 49 percent of basic salaries in 1994 and 63 percent in 1995, and totaling \$9 million for the 2 years. Total employee salaries at this company, as a percent of premium, were somewhat less than at other companies. However, when the profit-sharing bonuses—paid out of profits after all necessary program expenses were paid—were added to salaries, overall employee salaries at this company were 35-percent higher than the nine-company average. While company profit sharing may benefit a company in competing with another company for employees, the profit-sharing bonuses, which in this particular case seemed excessive, do not contribute to the overall sale and service of crop insurance or serve to enhance program objectives. Additionally, we identified profit-sharing bonuses totaling \$2.1 million reported as expenses at three other companies for 1994 and 1995. FCIC agrees that this type of expense goes beyond the reasonable expenses associated with the sale and service of crop insurance.

Similarly, we noted that two companies reported expenditures for management fees paid to parent companies as administrative expenses for crop insurance. Company representatives provided few examples of tangible benefits received in return for their payment of the management fee. We recognized management fees as a reasonable program expense to the extent that companies could identify tangible benefits received from parent companies. Otherwise, we considered payment of management fees to be a method of sharing income with the parent company and paid in the form of a before-profit expense item rather than as a dividend. These expenses totaled \$1.1 million for 1994 and 1995.

Although FCIC did not explicitly refer to these types of expenses in its last standard reinsurance agreement with companies, we discussed these expenses with FCIC. It agreed that to the extent the expenses exceed tangible benefits to the companies, they cannot be reasonably associated with the sale and service of crop insurance and thus should not be considered in determining an appropriate future reimbursement rate for administrative expenses.

Lobbying and Related Expenses

FCIC's standard reinsurance agreement with the companies precludes them from reporting expenditures for lobbying as crop insurance delivery expenses. Despite this prohibition, we found in our sample of company transactions that the companies included a total of \$418,400 for lobbying and related expenses in their expense reporting for 1994 and 1995. The

vast majority of these expenses involved lobbying by crop insurance trade associations.

Each company in our review paid membership fees to one or more crop insurance trade associations. Lobbying is one of the services provided to the companies by these associations. In accordance with Internal Revenue Service's rules, each industry trade association provided information to its members on the extent to which the payments to the association were used to fund lobbying activities. Nevertheless, none of the companies in our review excluded these expenses from their expense reports.

Expenses Reported in Error and Omitted Expenses

We also identified a number of errors and/or omissions in the companies' expense reporting. In 1994, the net effect of these errors and omissions was to reduce total company expenses by \$8.4 million, whereas in 1995, the net effect was to increase total company expenses by \$0.6 million.

In our review of companies' reported expenses, we identified various errors and/or omissions including expenses reported in the wrong year, expenses reported twice, and expenses not reported at all. Also, we found that five companies erred in reporting a total of \$1.8 million in state income taxes as an expense of selling and servicing crop insurance in 1994 and 1995. State income taxes are the result of successful crop insurance delivery and are not an administrative expense associated with the sale and service of crop insurance to farmers, whether the taxes are based on underwriting gains or on profits made from the delivery itself. To the extent that the taxes are based on profits from the delivery, they are not associated with the sale and service of crop insurance because, according to FCIC, companies are expected to earn profits from underwriting—not from administrative reimbursements. To the extent that the taxes are based on underwriting gains, they should not be recognized as an expense of delivering crop insurance.

Chapter 2
Administrative Expense Reimbursements
Paid by the Government Exceed Private
Companies' Expenses

Table 2.1: FCIC Reimbursements, Company Reported Delivery Expenses and GAO Adjustments for Nine Companies, 1994 and 1995

Dollars in thousands

Factors considered in calculating adequacy of expense reimbursement	1994		1995		Total
	Dollars	Percent of total premiums	Dollars	Percent of total premiums	
FCIC reimbursements to companies	\$236,544	31.0	\$343,632	31.4	\$580,176
Company-reported expenses	\$236,822	31.0	\$305,468	27.9	\$542,289
GAO's adjustments					
Expenses related to acquisition of other companies	(8,356)	(1.1)	(3,661)	(0.3)	(12,017)
Expenses related to managing underwriting risk	(5,416)	(0.7)	(5,322)	(0.5)	(10,738)
Expenses related to profit sharing through bonuses or management fees	(4,981)	(0.7)	(7,237)	(0.7)	(12,219)
Lobbying and related expenses	(114)	(0.0)	(305)	(0.0)	(418)
Errors and omitted expenses	(8,356)	(1.1)	626	0.1	(7,730)
Total adjustments	(\$27,223)	(3.6)	(\$15,899)	(1.5)	(\$43,122)
GAO's adjusted expenses reasonably associated with selling and servicing crop insurance	\$209,599	27.5	\$289,569	26.4	\$499,167
FCIC's reimbursements in excess of reasonable program expenses	\$26,945	3.5	\$54,063	4.9	\$81,008

Note: Totals may not add because of rounding.

Source: GAO's analysis of nine participating companies' data.

Collectively, as shown in table 2.1, for the nine companies we reviewed, we found that the expenses reasonably associated with the sale and service of buyup and catastrophic crop insurance combined were 27.5 percent of total premiums for 1994 and 26.4 percent for 1995. These rates are considerably lower than the 31 percent and 31.4 percent of total premiums paid by FCIC to reimburse the companies for these sales in those years. In total for 1994 and 1995, FCIC reimbursements exceeded delivery expenses by \$81 million. FCIC reviewed and agreed with our analysis and treatment of these expenses.

Appendix III provides a complete listing of those expenses that do not appear to be reasonably associated with the sale and service of federal crop insurance and should not be considered in determining an appropriate future administrative expense reimbursement. Appendix III also includes our rationale for expense adjustments. Appendix IV shows

the expenses for selling and servicing federal crop insurance as reported by the nine companies in our review and our presentation of the expenses reasonably associated with the sale and service of federal crop insurance. In addition, for 1995, appendix IV shows adjusted expenses as they relate to buyup and to catastrophic insurance. As shown in the appendix, for 1995, companies' adjusted expenses related to buyup insurance were 27.1 percent of premiums and expenses related to catastrophic insurance were 22.2 percent of premiums. In comparison, in 1995, companies received an administrative expense reimbursement for buyup insurance of 32.6 percent of buyup premiums and compensation for catastrophic insurance of 24 percent of premiums.

Other Reported Expenses Represent Opportunities to Lower Reimbursement Rates

We also found a number of expenses reported by the nine companies that, while in categories associated with the sale and service of crop insurance, seemed to be excessive in nature for a taxpayer-supported program and offer opportunities for FCIC to reduce future reimbursement rates. Collectively, controlling these expenses should reduce the average cost of selling and servicing crop insurance policies. These expenses included above-average commissions to agents on buyup policies; travel expenses, such as corporate aircraft and excessive automobile charges; and entertainment expenses, such as country club memberships and stadium sky box rentals. Each of these types of expenses is discussed below.

Agent Commissions

In the crop insurance business, participating companies compete with each other for market share through the sales commissions paid to independent insurance agents. To this end, companies offer higher commissions to agents to attract them and their farmer clients from one company to another. When an agent switches from one company to another, the acquiring company increases market share, but there is no net benefit to the crop insurance program. On average, the nine companies in our review paid agents sales commissions of 16 percent of buyup premiums they sold in 1994 and 16.2 percent in 1995. However, one company paid more—about 18.1 percent of buyup premiums sold in 1994 and 17.5 percent in 1995. When this company, which accounted for about 15 percent of all sales in these 2 years, is not included in the companies' average, commission expenses for the other eight companies averaged 15.6 percent of buyup premiums in 1994 and 15.8 percent in 1995. This company paid its agents about \$6 million more than the amount it would have paid had it used the average commission rate paid by the other eight

companies. According to FCIC officials, the agency plans to further study the issue of appropriate agent commissions.

Travel-Related Expenses

Employee travel is an essential part of selling and servicing crop insurance. Although FCIC has not provided specific guidance on appropriate expenses for travel, government travel regulations provide guidance as to what type of expenses might be appropriate when conducting business on behalf of the government. In our review of company-reported expenses, at eight of the nine companies we found instances of expenses that seemed to be excessive for conducting a taxpayer-supported program.

For example, we found that one company in our sample for 1994 reported expenses of \$8,391 to send six company managers (four accompanied by their spouses) to a 3-day meeting at a resort location. The billing from the resort included rooms at \$323 per night, \$405 in golf green fees, \$139 in charges at a golf pro shop, and numerous restaurant and bar charges. Our sample for 1995 included a \$31,483 billing from the same resort for lodging and other costs associated with a company “retreat” costing a total of \$46,857. Furthermore, we found in one instance, as part of paying for employees to attend industry meetings at resort locations, a company paid for golf tournament entry fees, tickets to an amusement park, spouse travel, child care, and pet care. The company reported these as delivery expenses for crop insurance.

Moreover, our samples of travel expenditures revealed instances of charges that appeared to involve the purchase of items not related to business. For example, at one company, our sample included charges to the company corporate charge card of \$107 at a department store, \$175 at a clothing store, \$165 at a country club gift shop, \$364 at a book and record shop, \$41 at an airport gift shop, \$209 at a resort gift shop, \$208 at a hotel gift shop, and \$928 from a cruise line. We found similar examples at five other companies.

Some companies incurred expenses associated with maintaining their own travel fleet. For example, one company owned a corporate jet and another leased an aircraft. Both employed full-time pilots. Subsequent to the years involved in our review, both companies decided it would be more cost-effective to rely more heavily on commercial flights instead of owned or leased aircraft. The companies we reviewed varied widely with respect to furnishing automobiles—from providing only a few pool automobiles,

to providing automobiles for a few officials, to providing automobiles for up to 45 percent of company employees. The types of vehicles also varied from luxury and sport utility to standard and economy.

FCIC's guidelines do not tell companies how they must spend their administrative expense reimbursement. However, in our opinion, if the current reimbursement provides companies with the opportunities to travel as described above, FCIC may be able to reduce its reimbursement rate and still reimburse companies for the reasonable expenses of selling and servicing crop insurance to farmers.

Entertainment Expenses

Recruiting new employees and maintaining employee morale is a reasonable business expense. However, our review of company expenses showed that some companies' entertainment expenditures appeared excessive for selling and servicing crop insurance to farmers. For example, one company spent about \$44,000 in 1994 for Canadian fishing trips for a group of company employees and agents. It also spent about \$18,000 to rent and furnish a sky box at a baseball stadium. Company officials said the expenditures were necessary to attract agents to the company. These expenditures were reported as travel expenses in 1994 and as advertising expenses in 1995. Moreover, the company's 1995 travel expenses included \$22,000 for a trip to Las Vegas for several company employees and agents. Similarly, our sample of company expenditures disclosed payment for season tickets to various professional sports events at two other companies; and six companies paid for country club memberships and related charges for various company officials and reported these as expenses to sell and service crop insurance.

Companies also purchased promotional items as gifts for agents and employees. For example, our 1994 sample of expenditures at one company included \$17,514 paid for 1,375 boxes of chocolates and \$8,242 paid to purchase 2,000 cookbooks as gifts to agents and employees.

While a number of the companies believe the type of expenses described above are important to maintaining an effective sales force and supporting their companies' mission, we believe that most of these expenses appear to be excessive for a taxpayer-supported program. These entertainment expenses may be helpful in competing for agents, but it is not clear how these types of expenses directly benefit either the farmer or the government in the delivery of crop insurance to farmers. We did not exclude the above items from our determination of necessary delivery

expenses because they were in categories that appear to be associated with crop insurance delivery. But FCIC agreed that these types of expenses may be excessive for a government-sponsored program like federal crop insurance.

Emerging Factors Have Increased Companies' Revenues

Several emerging factors affecting the crop insurance program have increased companies' revenues or may decrease companies' expenses. These factors include the following:

- higher crop prices and higher premium rates in 1996 and 1997 that resulted in higher premium income;
- expanded use of new types of revenue guarantee coverage (such as crop revenue coverage) that, for a higher premium, protects farmers against price drops between planting and harvest; and
- continuing simplification of program administrative requirements, potentially resulting in reduced company expenses.

Higher crop prices and higher premium rates could enable FCIC to reduce the administrative expense reimbursement by about 3 percent of buyup premiums below the adjusted expense level determined in our analysis of companies' 1994-95 expenses without diminishing service to farmers. New types of revenue guarantee coverage as well as simplification actions could serve to increase companies' revenues or decrease companies' expenses even further in the future. Each of these factors is discussed below.

Higher Crop Prices and Premium Rates

Two factors affecting the premiums paid by farmers have improved the income potential of crop insurance companies over the levels achieved in 1994 and 1995. These two factors are the (1) FCIC-projected market price of the commodity to be insured and (2) premium rate established by FCIC. When projected market prices and premium rates increase, the premiums that farmers pay increase. When the premiums that farmers pay increase, reimbursements to companies—which are currently paid on the basis of a percentage of premiums—increase proportionately without a proportionate increase in workload for the companies.

As shown in table 2.2, the projected market price FCIC used in establishing crop insurance premiums for six major crops increased 9.2 percent from 1995 to 1997, after the 1994-95 period we reviewed.

Chapter 2
Administrative Expense Reimbursements
Paid by the Government Exceed Private
Companies' Expenses

Table 2.2: Increase in FCIC's Projected Market Prices Used in Determining Crop Insurance Premiums

Crop	FCIC's projected market prices			Percent increase from 1995 to 1997
	1995	1996	1997	
Soybeans (per bushel)	\$5.50	\$6.75	\$6.15	11.8
Grain sorghum (per bushel)	2.10	2.50	2.30	9.5
Corn (per bushel)	2.25	2.65	2.45	8.9
Wheat (per bushel)	3.35	3.55	3.85	14.9
Peanuts (per pound)	0.34	0.34	0.34	0.0
Cotton (per pound)	0.68	0.67	0.69	1.5
Weighted average percent increase from 1995 to 1997 ^a				9.2

^aWeighted by 1995 crop insurance liabilities for each crop.

Source: GAO's analysis of FCIC's data.

Furthermore, to improve the actuarial soundness of the program, FCIC has increased the basic premium rates that are the other principal component of the crop insurance premiums.² From 1995 to 1996, basic premium rates for buyup insurance increased 3.6 percent, on average.³ FCIC projects premium rates to further increase in 1997. The increase in premium rates combined with the increase in crop prices resulted in an overall increase in premiums of about 13 percent. This increase occurred after the period we studied.

As a result of this increase in premiums, companies will receive a proportionate increase in their administrative expense reimbursement, about 3 percent of premiums, unless FCIC reduces the reimbursement rate. The additional 3 percent of premiums—the 13-percent increase in premiums multiplied by the 27.1 percent of premiums that we determined represents companies' expenses reasonably associated with the sale and service of buyup crop insurance in 1995—is in effect an unanticipated bonus to the companies and does not represent additional work for them.

²In 1995, we recommended that the Secretary of Agriculture raise crop insurance premium rates to improve actuarial soundness. See *Crop Insurance: Additional Actions Could Further Improve Program's Financial Condition* (GAO/RCED-95-269, Sept. 28, 1995).

³The increase is calculated from the earned premium rate—the ratio of total premiums to total liabilities—for buyup crop insurance.

This means that FCIC, at current crop price and premium rates, could reduce the administrative reimbursement for buyup insurance by about 3 percentage points and still reimburse companies for the reasonable expenses associated with selling and servicing crop insurance. Conversely, if premiums decline, the companies would receive a proportionate decrease in their expense reimbursement.

The increase in the companies' reimbursement resulting from the higher premiums that have occurred since 1995 will not be accompanied by a proportionate increase in the companies' workload. Company administrative work processes remain essentially the same regardless of the premium charged. For example, the cost of data entry and transmission is a function of the number of documents and data elements processed and transmitted, not the premiums those documents represent. Similarly, the cost of loss adjustment is a function of the frequency and nature of crop loss, not the premiums charged on the damaged crops. Thus, as premiums increase, the companies receive windfall increases in their income unless the reimbursement percentage is reduced.

Expanded Use of Revenue Guarantee Coverage

A second factor that may improve the companies' income potential is the introduction of a more expensive form of crop insurance. In 1996, FCIC approved a privately developed revenue guarantee crop insurance policy on a pilot basis in seven states. In January 1997, FCIC's board of directors authorized the expansion of this program to additional crops and states. The revenue guarantee policy protects producers against a decline in the value of the insured crop. The decline in value could occur because of crop loss, as with traditional crop insurance policies, or it could result from decline in commodity prices, or some combination of the two. Because of the increased risk borne by the revenue guarantee program, premiums are considerably higher than those charged for conventional crop insurance. Thus, because the companies' reimbursement is based on a percentage of total premiums, they will receive higher reimbursements without a commensurate increase in workload. A recent FCIC proposal addresses the potentially high administrative reimbursement associated with this product by limiting the administrative reimbursement for the price-risk aspect of the program.

Program Simplification Efforts

A third emerging factor affecting the crop insurance program may aid the companies in reducing their administrative expenses. As part of implementing the 1994 crop insurance reform act, FCIC and the crop

insurance industry jointly studied potential procedural changes that could result in simplifying or streamlining program delivery processes. As of January 1997, FCIC had completed action on 26 simplification projects identified by the study group and was continuing to study 11 additional potential changes. Simplification projects FCIC has implemented include

- restructuring actuarial documents, thereby reducing printed pages by one-third;
- providing actuarial documents electronically;
- simplifying processing of small claims;
- authorizing companies to correct obvious and incidental errors directly;
- integrating various options and endorsements into crop insurance policies; and
- implementing a single insurance policy format for most crops.

Neither FCIC nor the companies could precisely quantify the amount of savings that can be expected from these changes, but they agreed that the changes were necessary and collectively may reduce costs somewhat. Industry representatives emphasized that FCIC should continue to emphasize simplifying the delivery procedures. FCIC officials agreed but noted that any changes must be carefully analyzed on the basis of their impact on the actuarial soundness of the crop insurance program. Appendix I provides a more detailed discussion of these changes and their potential effects.

Conclusions

On the basis of our review of companies' reported expenses and emerging factors in the crop insurance industry, we believe that the current expense reimbursement rate paid to participating companies exceeds the reasonable expenses associated with selling and servicing crop insurance. Our review showed that for 1994 and 1995, the actual expenses reasonably associated with the sale and service of buyup crop insurance for the nine companies in our review were about 27 percent of premiums—4 percentage points below the 31-percent base reimbursement rate paid to companies—and that FCIC could reduce rates another 3 percent of premiums because of higher crop prices and increased premiums in 1996 and 1997 that provided companies with higher reimbursements without any additional work. This would still provide participating companies with adequate reimbursement for the reasonable expenses associated with selling and servicing crop insurance. The 1994 reform act directs FCIC to reduce the overall reimbursement for buyup insurance to no more than 27.5 percent of total premiums in 1999.

However, we believe that the administrative reimbursement rate can be reduced to a lower level at the current time—in the range of 24 percent. Our analysis also showed that the compensation for catastrophic insurance exceeded the companies' expenses that can be reasonably associated with selling and servicing catastrophic insurance, although to a lesser extent.

Recommendations to the Secretary of Agriculture

We recommend that the Secretary of Agriculture direct the Administrator of the Risk Management Agency to

- determine the administrative expense reimbursement rate that reflects the appropriate and reasonable costs of selling and servicing traditional buyup insurance and include this rate in the new agreement currently being developed with the companies;
- determine the compensation that reflects the appropriate and reasonable costs of selling and servicing catastrophic crop insurance and include it in the new agreement currently being developed with the companies;
- explicitly convey to participating insurance companies the type of expenses that the administrative reimbursement is intended to cover; and
- monitor companies' expenses to ensure that the established rate is reasonable for the services provided.

USDA and Crop Insurance Industry Comments

Overall, USDA's Risk Management Agency agreed with the information presented in the draft report and its conclusions and recommendations. In its proposed 1998 standard reinsurance agreement with the private insurance companies, FCIC has included changes to the expense reimbursement rate for delivering both buyup and catastrophic insurance. Additionally, in this proposed agreement, FCIC has clarified the types of expenses that the administrative reimbursement is intended to cover, and it plans to monitor companies' expenses in the future as a result of our review. USDA's Risk Management Agency also examined the methodology used to conduct the review and found no fault in it.

In responding to our report, the industry raised questions about the methodology we used in our analysis of companies' reasonable delivery expenses, including (1) the time period we examined; (2) the standards we used to judge allowability of expenses; and (3) the applicability of emerging factors, such as increased premiums and higher crop prices. In addition, without being specific, the industry stated that a lower

reimbursement rate—in the range of 24 percent—would “destabilize” the industry.

With respect to the time period examined, we selected 1994 and 1995 to provide a picture of expenses for delivering crop insurance before and after the implementation of the 1994 reform act. Furthermore, these were the first 2 years that the industry consistently provided the detailed data in a format needed to fully analyze the expenses associated with the selling and servicing of crop insurance. The industry stated that we understated administrative expenses by using 2 years in which crop losses were relatively low. We disagree. Crop losses for buyup coverage in 1995 were equal to or higher than crop loss experiences throughout the 1990s, except for 1993. Furthermore, we found that high crop losses did not significantly increase companies' loss-adjusting expenses—the delivery cost factor most likely to be affected by high crop losses. For example, for buyup insurance, while companies paid out \$1.28 in loss claims for every dollar of premium received in 1995 and \$0.58 in loss claims for every dollar of premium received in 1994, their related loss adjusting expenses as a percent of premium for these 2 years were not substantially different. Therefore, although losses were higher in 1995 than in 1994, the companies' loss adjusting expenses for processing these claims did not increase commensurately. In addition, loss adjusting expenses are not a significant portion of total administrative expenses (about 3.5 percent of premiums on average for the nine companies we reviewed). Furthermore, since the 1980s, the crop insurance companies have received additional reimbursements in years of high crop losses.

Second, the standards we used to identify reasonable costs for delivering crop insurance were developed on the basis of a number of different widely recognized accounting, insurance, and acquisition standards. FCIC agreed that the standards used were appropriate. We recognized all expenses reasonably associated with selling and servicing crop insurance. However, we continue to believe that the government should not be expected to reimburse companies for such expenses as those related to maximizing underwriting gains, acquiring other companies' business, payments to executives to refrain from joining or starting other companies, payments to parent companies with no measurable benefits to the program, profit-sharing bonuses, and payments to lobbyists. We believe that these expenses should not be included in determining an appropriate future reimbursement rate for administrative expenses.

Third, two factors that have emerged since the 1994-95 time period that we reviewed—higher premium rates and higher crop prices in 1996 and 1997—should be considered in evaluating the appropriate, future reasonable reimbursement rate because these factors did increase companies' revenues without increasing expenses. Furthermore, USDA projects that crop prices will generally increase through 2005. If crop prices decline, FCIC could reevaluate the reimbursement rate.

Finally, we disagree that a lower reimbursement rate—in the range of 24 percent—would destabilize the industry. Such a rate represents the companies' current expenses that are reasonably associated with the sale and service of crop insurance and as a result should not diminish service to the farmer nor destabilize the program. Companies will still have the opportunity to realize underwriting profits. In 1994 and 1995, for example, the companies realized underwriting profits of \$103 million and \$133 million, respectively.

(See apps. VIII and IX for the industry's comments and our detailed response.)

USDA Delivered 1995 Catastrophic Insurance at Lower Cost to Government Than Private Companies

In 1995, farmers without crop insurance were required to purchase catastrophic risk protection insurance to participate in federal farm programs—a requirement that was rescinded in 1996. Farmers could purchase catastrophic insurance either from USDA's FSA local offices or from an authorized local insurance agent. In 1995, it was more costly for the government to deliver catastrophic insurance through private companies than through USDA. When basic delivery costs were offset by income from farmer-paid processing fees, the costs to the government for selling and servicing catastrophic insurance in 1995 were comparable for both USDA and private companies. However, delivery through private companies was more costly to the government because the companies retained an estimated \$45 million underwriting gain. In 1995, FCIC's long-term target for underwriting gain was 7 percent on the premiums for which the companies retained risk. However, in 1995, the underwriting gain paid by FCIC to the companies was about 37 percent. FCIC is currently studying the issue of an appropriate long-term rate of return for companies participating in the program. Legislation passed in 1996 requires USDA to move delivery of catastrophic insurance solely to private companies, where feasible.

Cost to the Government in 1995 for USDA Delivery Less Because of Underwriting Gain Paid to Companies

In 1995, the total cost to the government to deliver catastrophic insurance was less when provided through USDA than through private companies. The total cost to the government to deliver catastrophic insurance consists of three components: (1) basic sales and service delivery costs, (2) offsetting income from processing fees paid by farmers, and (3) company-earned underwriting gains. When only the first and second components were considered, the costs to the government for both delivery systems were comparable. However, the payment of an underwriting gain to companies, the third component, made the total cost of company delivery more expensive to the government.

With respect to the first component—the costs of basic sales and service delivery—the cost to the government was higher when provided through USDA. The costs of basic sales and service for USDA's delivery included expenses associated with activities such as selling and processing policies, developing computer software, training adjusters, and adjusting claims. This cost also included indirect or overhead costs such as general administration, rent, and utilities. Included in the 1995 direct and indirect costs for USDA delivery was the Department's one-time start-up costs for establishing the USDA delivery system. Direct costs for basic delivery through USDA amounted to about \$91 per crop policy, and indirect costs

amounted to about \$42 per crop policy, for a total basic delivery cost to the government of about \$133 per crop policy. Appendix V provides more detail on the components of total government costs to deliver catastrophic insurance through USDA and insurance companies.

The basic delivery cost for company delivery consists of the administrative expense reimbursement paid to companies by FCIC and the cost of administrative support provided by USDA. The administrative expense reimbursement amounted to about \$73 per crop policy, and USDA's support costs amounted to about \$10 per crop policy, for a total basic delivery cost to the government for company delivery of about \$83 per crop policy.

The second component—offsetting income from farmer-paid processing fees—reduced the basic delivery cost to the government for both delivery systems, but had a much larger impact in reducing the cost to the government for the USDA delivery system. In 1995, farmers buying catastrophic insurance were required to pay a \$50 processing fee for each crop they insured, up to certain limits. For USDA's delivery, processing fees paid by farmers reduced the government's basic delivery cost of about \$133 by an average of \$53 per crop policy.¹ For company delivery, fees paid by farmers and remitted to the government reduced the government's basic delivery cost of about \$83 by \$7 per crop policy. For company delivery, the effect on the cost to the government was relatively small because the 1994 reform act authorized the companies to retain the fees they collected from farmers up to certain limits. Only those fees that exceeded these limits were remitted back to the government. Combining the basic sales and service delivery costs and the offsetting income from farmer-paid processing fees, the government's costs were comparable for both delivery systems.

The third component—underwriting gains paid by FCIC only to the companies—is the element that made delivery through USDA less expensive. The insurance companies can earn underwriting gains in exchange for taking responsibility for any claims resulting from those policies for which the companies retain risk. In 1995, companies earned an underwriting gain of an estimated \$45 million, or about a 37-percent return on the catastrophic premiums for which they retained risk. This underwriting gain increased the government's delivery cost for company delivery by \$127 per crop policy. Underwriting gains are, of course, not guaranteed. In years with a high incidence of catastrophic losses,

¹This \$53 amount was calculated using data provided by FCIC on 803,438 crop policies sold by local FSA offices and \$42,822,950 in fees collected.

companies could experience net underwriting losses, meaning that they would have to pay out money from their reserves in excess of the premiums paid to them by the government, potentially reducing the government's total cost of company delivery in such years.

Table 3.1 summarizes the three components of the government's cost to deliver catastrophic insurance through USDA and companies in dollars per crop policy for 1995.

Table 3.1: 1995 Cost Per Crop Policy for Government's Cost to Deliver Catastrophic Insurance Through USDA and Private Companies

Components of cost to government	Government cost of USDA delivery	Government cost of company delivery
Basic delivery cost	\$132.72	\$83.37
Less: fees remitted to government	53.30	7.21
Subtotal cost to government	\$79.42	\$76.16
Plus: underwriting gain paid to companies	n/a	127.06
Total cost to government	\$79.42	\$203.22

Source: GAO's analysis of USDA's data.

The table shows that, overall, the government's cost for delivering catastrophic insurance through USDA was about \$124 less per crop policy than the delivery cost through companies in 1995.

The 1995 catastrophic underwriting gain of about 37 percent was the critical component in the difference in comparative costs between USDA and company delivery. This gain was substantially higher than FCIC's established long-term target of 7 percent for underwriting gains on the catastrophic premiums for which the companies retain risk. According to FCIC's Senior Actuary, the large underwriting gain in 1995 may have been unusual. However, the program's experience in 1996 suggests that the large underwriting gain in 1995 may not be that unusual; 1996 underwriting gains were even higher—about \$58 million. FCIC is currently studying the issue of an appropriate long-term rate of return for companies participating in the program.

1996 Legislation Directs USDA to Move Toward More Private Company Delivery of Catastrophic Insurance

Beginning with crops harvested in 1997, the Federal Agriculture Improvement and Reform Act of 1996 requires that USDA's delivery of catastrophic insurance be transferred to private companies in areas where there are sufficient private company providers. In July 1996, the Secretary of Agriculture, after consultation with approved insurance providers, identified 14 states in which USDA would no longer deliver catastrophic policies. Effective for the 1997 crop year, catastrophic policyholders in these 14 states who purchased catastrophic coverage from USDA were either to select a local private company or be assigned by USDA to a local private company. The 14 states are Arizona, Colorado, Illinois, Indiana, Iowa, Kansas, Minnesota, Montana, Nebraska, North Carolina, North Dakota, South Dakota, Washington, and Wyoming.

According to the American Association of Crop Insurers, crop insurance industry executives unanimously support securing the remaining 36 states for private delivery, beginning with crops harvested in 1998. According to the Federal Agriculture Improvement and Reform Act of 1996, the Secretary of Agriculture must make the announcement for any additional states where USDA delivery is to be phased out by April 30 of the year preceding the year in which the applicable crops will be harvested.

Conclusions

If only 1995 is considered, the delivery of catastrophic insurance through USDA is less expensive to the government than through companies because of the underwriting gains companies earned. These gains, 37 percent of catastrophic premiums on which the companies retained risk, were far higher than FCIC's long-term target gain of 7 percent. Over time, gains and losses may offset each other, and the target gain may be realized. However, if underwriting gains do not become more commensurate with FCIC's target gain, the potential for high government costs and high company profits will continue. FCIC is aware of this situation and is currently studying the issue of an appropriate long-term rate of return for companies participating in the program. Furthermore, this issue of potentially high costs and high profits takes on added importance because of the requirements of the Federal Agriculture Improvement and Reform Act of 1996. This act requires USDA to transfer its delivery of catastrophic insurance to private companies in areas where there are sufficient private company providers.

Recommendation to the Secretary of Agriculture

We recommend that the Secretary of Agriculture direct the Administrator of the Risk Management Agency to closely monitor the experience of the catastrophic insurance program to ensure that over time the underwriting gains earned on catastrophic insurance by the companies do not routinely exceed FCIC's long-term target.

USDA and Crop Insurance Industry Comments

FCIC agreed with our conclusions and recommendation and has already changed the proposed 1998 standard reinsurance agreement to ensure that underwriting gains on catastrophic insurance will be more closely in line with its long-term target.

The industry, however, questioned our methodology for comparing the cost to the government of the USDA and company delivery systems. Specifically, it stated that the processing fees paid by farmers and the underwriting gains paid to companies should not be considered in analyzing the costs to the government for catastrophic insurance delivery. It also suggested that restricting our analysis to 1995 provided a distorted picture of underwriting gains because it only represented 1 year's experience. It further stated that our analysis did not take into account that, in its view, the quality of service provided to farmers by the companies was much higher than that provided by USDA.

We disagree that an analysis of the comparative costs to the government of company- and USDA-delivered catastrophic insurance should exclude the processing fee and underwriting gains components. In computing the overall costs to the government, all revenue and payment components have to be considered. With respect to the industry's concern about our period of analysis, 1995 was the only year in which a comparative assessment could be made at the time we conducted our review because it was the only year in which both USDA and the companies were delivering catastrophic insurance. Since then, however, we note that underwriting gains paid to the companies in 1996 exceeded those paid in 1995. This would serve to make the cost to the government for company-delivered catastrophic insurance even higher. With respect to the issue of comparative service quality, we did not make this a principal focus of our review. However, during the course of our work, we found little to suggest that the service provided by companies or USDA was less than satisfactory.

The industry's comments also indicate that it believes our conclusions might mislead public policymakers by implying that delivery of catastrophic insurance by private industry should be reduced. We do not

believe that this is the case. We did not conclude or recommend that the industry should have its role in catastrophic insurance delivery reduced. We do hold the view, however, that the level of underwriting gain paid to the companies should be managed so that it more closely follows FCIC's target.

Alternative Expense Reimbursement Arrangements Offer Potential for Savings

The current method for reimbursing administrative expenses for buyup insurance—whereby FCIC pays private companies a fixed percentage of premiums—has certain advantages, including ease of administration. However, expense reimbursement based on a percentage of premiums does not necessarily reflect the amount of work or cost involved to sell and service crop insurance policies. We identified four alternative reimbursement arrangements that offer the potential to reduce FCIC's reimbursements and to more closely match reimbursements with expenses. Each has advantages and disadvantages. Industry leaders prefer FCIC's current reimbursement method because it is relatively simple to administer and because they believe that most alternatives could reduce their reimbursements.

Four Alternatives to the Current Reimbursement Arrangement

Through our discussions with FCIC and crop insurance industry officials, we identified the following four alternatives to the current expense reimbursement method that offer potential cost savings to the government and may more closely match FCIC's reimbursements with companies' expenses:

- place a cap on the amount reimbursed per policy;
- reimburse companies a flat fee per policy, plus a reduced percentage of premiums;
- reimburse companies according to a schedule of allowable expenses; and
- reduce reimbursement rates as companies' total premium volume increases.

Currently, FCIC calculates administrative expense reimbursements by multiplying companies' total written premiums by a set reimbursement percentage, regardless of the expenses incurred by the company to sell and service crop insurance. Table 4.1 shows the 1995 distribution of premiums and reimbursements for certain buyup policies for all participating companies.¹

¹We limited our analysis to policies with "additional" coverage—the most frequently purchased type of coverage. Additional coverage includes coverage equal to or greater than 65 percent of the yield guarantee at 100 percent of the projected market price. These policies represented about 65 percent of the crop insurance premiums written in 1995. Although farmers are permitted to select different coverage levels for their operational units, they are also permitted to purchase one policy covering their entire farming operations. Our analysis was limited to those policies with additional coverage for the entire farming operation. See app. VI.

Table 4.1: 1995 Distribution of Premiums and Reimbursements, Total and Average Per Policy

Premium range		Premiums		Number of policies		1995 reimbursement		
From	To	Total (\$000)	Average per policy	Count	Percent by range	Total (\$000)	Percent by range	Average per policy
\$1	\$499	\$39,627	\$213	186,156	43.6	\$12,284	4.9	\$66
500	1,499	101,957	900	113,321	26.5	31,607	12.5	279
1,500	4,999	247,675	2,723	90,956	21.3	76,779	30.4	844
5,000	9,999	162,669	6,853	23,736	5.6	50,428	20.0	2,125
10,000	49,999	222,070	17,421	12,747	3.0	68,842	27.3	5,401
50,000	99,999	23,905	65,674	364	0.1	7,411	2.9	20,359
100,000	499,999	14,097	167,821	84	0.0 ^a	4,370	1.7	52,024
500,000	& up	2,044	1,021,993	2	0.0 ^a	634	0.3	316,818
Total		\$814,045	\$1,905	427,366	100.0	\$252,354	100.0	\$590

Note: Totals may not add because of rounding.

^aAmount less than 0.1 percent.

Source: GAO's analysis of FCIC's data.

Each of the four alternatives, as discussed below, has the potential to more closely match FCIC's expense reimbursements to the expenses actually incurred by the companies for the sale and service of crop insurance. In addition to having cost savings potential, the four alternatives offer specific advantages and disadvantages. To illustrate the four alternatives, we applied them to the 1995 experience data shown in table 4.1

Alternative 1—Place a Cap on Reimbursements Per Policy

Under the current reimbursement arrangement, as policy premiums increase, the companies' reimbursement from FCIC for administering the policies increases. However, the workload, or cost, associated with administering the policy generally does not increase proportionately. Therefore, for policies with the highest premiums, there may be a large differential between FCIC's reimbursement and the costs incurred to administer those policies. For example, in 1995, the largest 3 percent of the policies received about one-third of the total reimbursement. In fact, the five largest policies in 1995 had reimbursements ranging from about \$118,000 to \$472,000. FCIC could reduce its total expense reimbursements to companies by capping, or placing a limit on, the amount it reimburses companies for the sale and service of crop insurance policies.

Alternative 2—Pay a Flat Amount Per Policy Plus a Percentage of Premiums

For each crop insurance policy written, an insurance company must perform some minimum level of work, regardless of the premium. The company, usually through an agent, must obtain, record, and process certain basic policy information. The company performs additional work that varies, generally depending on the size of the farm and value of the crops insured. A larger farm may require more time to measure and inspect the component fields and more contacts with the farmer. This alternative is designed to recognize both the fixed and variable aspects of selling and servicing crop insurance policies. For example, FCIC could reimburse companies a fixed amount (such as \$100) for each policy written to pay for the fixed expense associated with each policy. In addition, FCIC could pay a percentage of premiums to compensate companies for the variable expenses associated with the size and value of a policy.

Alternative 3—Tie Reimbursements to Schedule of Allowable Expenses

Administrative expense reimbursements could be tied to the cost of performing specific services that benefit the crop insurance program. For example, most government contractors are paid on the basis of the Federal Acquisition Regulation (FAR),² which establishes a schedule of allowable expenses. Using the FAR, a contractor providing goods and services to the federal government submits a bill that is audited against a schedule of allowable expenses, and subsequently, the government pays an adjusted amount to the contractor, if appropriate. Using this approach, the amount paid would include only reimbursement for allowed expenses. FCIC could limit the overall reimbursement rate and limit the reimbursement rate for specific components, such as commissions, data processing, and travel. Companies could also be required to follow federal guidelines to reimburse employees or contractors for any travel.

Alternative 4—Reduce Reimbursement Rates as Premium Volumes Increase

Assuming companies can realize some economies of scale for certain cost items, FCIC could reduce the reimbursement rates for individual companies as their written premium volumes increase. For example, some expenses, such as underwriting and overhead, are based on fixed expenses, such as investments in equipment and facilities, annual training, and state licenses and fees. These types of fixed expenses decrease as a percent of total premiums written as premium volume increases. Currently, FCIC pays the same percent of written premiums to participating companies regardless of the companies' size of operation or premium amount written. Under this

²48 C.F.R. chapter 31 et seq.

alternative, FCIC would reimburse companies on a sliding scale based on premium volume.

Each Alternative Has Potential Advantages and Disadvantages

We found that all four alternatives have the potential to reduce FCIC's reimbursement for administrative expenses. Each alternative, however, has advantages and disadvantages compared with the current reimbursement arrangement. For example, some alternatives have the advantage of possibly encouraging smaller companies to participate in the program. On the other hand, some alternatives have the potential disadvantage of increasing the administrative burden on FCIC or decreasing incentives for participating companies to deliver crop insurance. The potential advantages and disadvantages of each alternative are discussed below.

Place a Cap on Reimbursements Per Policy

Under this alternative, FCIC could realize the largest amount of administrative reimbursement savings while only affecting a relatively small percentage of policies. This alternative would eliminate high reimbursement payments for large or high-premium policies. To illustrate, to calculate potential cost savings using this alternative, we capped the administrative expense reimbursements on individual policies at three different levels—\$1,550, \$3,100, and \$6,200—affecting about 9, 3, and 1 percent, respectively, of policies in 1995. Potential savings generated from this alternative would depend at what level the cap was established, as shown in table 4.2.

Table 4.2: Potential Savings Depend on Reimbursement Cap Level

Per policy reimbursement cap	Premiums per policy related to reimbursement cap	Alternative reimbursement (dollars in millions)	Potential savings (dollars in millions)	Percent of policies affected by cap	Average reimbursement as a percent of total premium
\$1,550	\$5,000 and above	\$177.9	\$74.4	8.6	21.9
3,100	10,000 and above	212.0	40.3	3.1	26.0
6,200	20,000 and above	234.1	18.2	0.9	28.8

Note: Reimbursement is based on 31 percent of premiums.

Source: GAO's analysis of FCIC's 1995 data.

As shown in the table, a \$3,100 cap would have created a \$40.3 million savings while reimbursing companies at the 31-percent reimbursement

level for more than 95 percent of the policies written in 1995. Only about 3 percent of all policies written would have been affected by using a \$3,100 cap on reimbursements. Decreasing the cap to \$1,550 would have provided savings to the government of about \$74 million while limiting reimbursements on less than 10 percent of the policies written in 1995.

Although offering the potential for significant cost savings, this alternative has the disadvantage of possibly discouraging some companies from aggressively marketing larger crop insurance policies for FCIC.

Paying a Flat Amount Per Policy Plus a Percentage of Premiums

This alternative offers a potential for cost savings that is somewhat less than capping reimbursements at \$1,550 per policy, but it may encourage companies to sell small-premium policies. To illustrate the potential for cost savings, we selected three different reimbursement combinations. As shown in table 4.3, if FCIC reimbursed companies a fixed \$100 reimbursement per policy plus 17.5 percent of the premiums, the overall average reimbursement rate would be 22.8 percent. Compared with the 1995 reimbursement method, this approach would produce a savings of 8.2 percent of premiums, or about \$67 million, from the 31 percent reimbursement rate. Table 4.3 also illustrates other reimbursement combinations.

Table 4.3: Savings Potential for Different Reimbursement Combinations

Alternative reimbursement arrangements	Alternative 1995 reimbursement			
	Alternative reimbursement (dollars in millions)	Average per policy	Average reimbursement as a percent of premium	Potential savings (dollars in millions)
20 percent plus \$100 per policy	\$205.5	\$480.96	25.3	\$46.8
17.5 percent plus \$100 per policy	185.2	433.34	22.8	67.2
17.5 percent plus \$150 per policy	206.6	483.34	25.4	45.8

Source: GAO's analysis of FCIC's 1995 data.

Because one component of the reimbursement would be a flat fee regardless of premium size, reimbursements for small, or low-premium, policies under this alternative may exceed reimbursements for these kinds of policies under the current system. This may encourage sales and service to smaller farmers, a goal advanced by some crop insurance observers.

This alternative has the further advantage of more closely matching FCIC's reimbursement to the administrative workload of the companies and their agents. Finally, unlike the previous alternative that capped reimbursements, reimbursements under this alternative would still be linked in part to premiums. Therefore, companies will continue to have an incentive to sell higher coverage.

This alternative has the disadvantage of requiring FCIC to more closely monitor companies to ensure they do not generate additional policies solely to increase their revenue.

Tying Reimbursements to Schedule of Allowable Expenses

This alternative would offer FCIC the opportunity to better control the expenses to be reimbursed by paying participating companies according to a schedule of allowable expenses for performing specific services, such as selling and writing a policy, processing a policy, and adjusting claims. Companies could be required to reimburse employees or contractors for any travel according to federal reimbursement guidelines for travel. Using the FAR, a contractor providing goods and services to the federal government submits a bill that is audited against a schedule of allowable expenses, and subsequently, the government pays an adjusted amount to the contractor, if appropriate. Savings under this alternative would depend upon the rates agreed to by FCIC and the companies. In addition, this alternative could provide participating companies with additional protection during years with high crop losses by reimbursing them for the actual loss-adjusting expenses they incur.

A major disadvantage of this alternative is that FCIC would need to increase its oversight of participating companies' financial operations. FCIC would need to draft and approve additional regulations, audit expense vouchers against a schedule of allowable expenses, and require participating companies to follow additional regulations.

Reducing Reimbursement Rates as Premium Volumes Increase

This alternative offers the advantage of potential cost savings and may encourage smaller companies' participation in the program. Some industry observers have expressed concern at the decline in the number of participating companies—from 49 in 1985 to 19 in 1995. For this reimbursement alternative, companies could be reimbursed at a higher rate for their first level of business and at a reduced rate at higher premium levels. To illustrate, we calculated results using declining reimbursement rates for premium levels of \$20 million and below; over \$20

to \$50 million; over \$50 to \$100 million; and over \$100 million. Table 4.4 shows the results of our analysis.

Table 4.4: Savings Potential for Declining Reimbursement Rates

Company premium volume range (dollars in millions)	1995 premiums (dollars in millions)	Alternative reimbursement		Potential savings (dollars in millions)
		Percent	Amount (dollars in millions)	
\$20 and below	\$279.3	31.0	\$86.6	\$0.0
Over \$20 to \$50	195.2	29.0	56.6	3.9
Over \$50 to \$100	196.1	27.0	52.9	7.8
Over \$100	143.5	25.0	35.9	8.6
Total/average	\$814.1	28.5	\$232.0	\$20.4

Note: Totals may not add because of rounding.

Source: GAO's analysis of FCIC's data.

At the indicated premium levels, in 1995, this alternative had the potential to save the government about \$20.4 million in administrative expense reimbursements while having minimal or no impact on participating companies. Of the 19 participating companies, 10 wrote total premiums of \$20 million or less, and therefore this alternative would have had no effect on the amount of reimbursements paid to these 10 companies. Only 3 of the 19 companies wrote premiums in excess of \$100 million.

Compared with the current system, this alternative would have the effect of favoring smaller companies over larger companies. To the extent that smaller or nonparticipating companies perceive that larger companies do not have a competitive advantage based on the size of operations, they may see increased opportunities to stay in or enter the industry. This outcome would be viewed as an advantage by those who want to see an increase in the number of participating firms.

A disadvantage of this alternative is that it could discourage some larger companies from aggressively delivering crop insurance for FCIC. Furthermore, to the extent that selling and servicing crop insurance policies are subject to economies of scale, such economies may not be achieved if companies do not expand their operations.

Participating Companies Generally Prefer Current Reimbursement Arrangement

According to crop insurance industry officials, participating companies generally prefer the current reimbursement arrangement because they believe that most alternatives would reduce their reimbursements and increase their administrative workload. Officials at some participating companies also said that alternative arrangements would reduce their incentives to deliver federal crop insurance if their overall revenues from reimbursements were reduced. Several company officials also stated that any reduced administrative reimbursements would increase the need for FCIC to provide additional opportunities for underwriting gains. In addition to continuing the current reimbursement arrangement, participating companies want FCIC to simplify administrative requirements. They believe some of the existing requirements are needlessly costly and unnecessary to ensure the integrity of the program. Appendix I provides more information about FCIC's efforts to simplify crop insurance program administration.

USDA and Crop Insurance Industry Comments

USDA's Risk Management Agency concurred with our draft report's treatment of alternative reimbursement arrangements. In its 1998 standard reinsurance agreement, FCIC has proposed using the second alternative—having the government pay a flat amount per policy and a percentage of premiums.

The crop insurance industry stated that we made recommendations to make major changes to the reimbursement system and that these changes would most likely, among other things, greatly undermine agents' compensation. We did not recommend one alternative over another or over the current system but instead described the arguments for and against the major alternatives that we identified. In so doing, we were complying with the 1994 mandate.

Furthermore, throughout our report and in this chapter, we focused on the effects on companies, not on the agents. Companies may compensate their agents in ways that they consider appropriate, regardless of the companies' arrangement with the government. (See apps. VIII and IX.)

Simplification and Paperwork Reduction

This appendix summarizes the Federal Crop Insurance Corporation's (FCIC) reported progress in simplifying administrative requirements placed on companies delivering crop insurance for the federal government. The Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 required FCIC to initiate efforts to simplify the administrative burden placed on companies.

Since implementation of the reform act in October 1994, FCIC has worked with an industry group to identify and implement simplification actions without jeopardizing program soundness. The list below summarizes FCIC's reported progress as of January 1997. According to U.S. Department of Agriculture (USDA) officials, in considering future simplification actions, USDA will continue to measure the effect of these actions on farmers and the program's actuarial soundness.

Simplification Actions Completed

1. FCIC restructured actuarial documents, such as premium rate and special provision tables, to provide pertinent information on fewer pages. This reduced the number of pages printed each year by one-third, or approximately 2 million pages.
2. FCIC began providing all actuarial tables electronically to companies, instead of in hard copy. This change reduced delivery time to participating companies and saved the government from printing 4 million pages per year.
3. FCIC established a limited-access computer server for reinsured companies' use. Now, companies can call in by modem and download relevant program information, such as premium rates, policy information, FCIC bulletins, and other company-specific information.
4. FCIC established a public-access computer server (i.e., an Internet web site) and placed a large amount of relevant crop insurance data on the server. This capability allows FCIC to provide more information to the public more quickly and reduces the waiting time previously associated with FCIC's processing of special requests for computerized information.
5. FCIC analyzed its basic crop insurance computer system to ensure that it contained no unnecessary or redundant data requirements. On the basis of this analysis, FCIC implemented processes to minimize companies' preparation and reporting time and reduce rejections of program data.

6. FCIC expanded the availability of the Group Risk Plan insurance. This coverage option requires less analysis of farm programs to underwrite a policy and reduces the amount of time required to settle a claim, relying on general, published data rather than producer-specific data.

7. FCIC eliminated the Group Risk Plan's preliminary payment feature, saving the companies, agents, farmers, and FCIC additional follow-up and reconciliation work.

8. FCIC made Group Risk Plan coverage for forage available at the catastrophic level. Since forage insurance is a very complex product to administer, expanding the pilot program to provide catastrophic coverage provides simplification benefits to everyone involved.

9. FCIC introduced the Tropical Fruit Tree crop insurance plan in Florida. The plan eliminates significant up-front administrative work by insuring the tree rather than the fruit. Time-consuming paperwork is now only required at loss adjustment time and only for those policies that have losses.

10. FCIC approved an express claims pilot project for a variety of crops for all locations. This simplified process for handling small claims allows companies to settle smaller claims more quickly and at a lower administrative cost. FCIC will monitor this pilot project to ensure that the use of this process does not lead to increased underwriting losses.

11. FCIC eliminated the requirement that companies prorate prevented planting acres. Prior to this change, companies were required to perform a number of detailed measurements and calculations when there was more than one insurance unit and crop on a policy. Eliminating this requirement should save administrative effort and cost, but it could expose FCIC to additional losses. FCIC will need to continue monitoring the results of this change.

12. FCIC approved the use of combined forms, on a company-by-company basis. For example, producers will be able to report actual production history data and intended acres on one form and then update this form with actual acreage data if different. According to FCIC, these combined forms allow companies to reduce the number of times that they must contact the farmer.

13. FCIC implemented a computerized system to track policyholders. This system allows insurers to verify certain facts without making time-consuming, in-person checks with local offices, other companies, or FCIC. The data that can be verified include, for example, the producer's (1) insurance status the prior year and (2) compliance with conservation compliance requirements.

14. To save time and reduce policyholder and company visits, FCIC has combined a number of policy dates. For example, FCIC may have had sales-closing dates for different crops in the same area for October 31, November 1, and November 15. To the extent permitted by sound underwriting principles, one closing date has been established for as many crops as possible. FCIC's crop insurance program has many different dates, including sales-closing, acreage-reporting, production-reporting, final-planting, late-planting, end-of-insurance period, cancellation and termination. These dates vary across the almost 40,000 county crop programs. Batching dates together whenever possible makes it easier for farmers, agents, and others to remember to perform all required tasks in a timely manner.

15. FCIC gave participating companies expanded authority to issue individualized insurance endorsements for farmers with particular needs. In the past, prior FCIC approval was required for most of these special endorsements; now, companies may issue more types of agreements without obtaining FCIC's approval for each individual producer.

16. FCIC authorized companies to correct obvious and inadvertent errors, such as digit reversals and misplaced data entries without obtaining FCIC's consent in each case.

17. FCIC integrated selected policy options and endorsements into the standard crop insurance policy. Now, endorsements can be activated automatically when farmers choose them during the normal application process. Previously, each company was often required to process a separate application and issue a separate document.

18. FCIC simplified the corn grain/silage loss provisions. Implementing this change makes it easier for farmers to calculate and report harvested grain as silage, when appropriate.

19. FCIC standardized and simplified the type and practice codes used to distinguish between different types or varieties of a crop (i.e., early versus

late oranges) or management practices (i.e., irrigated versus nonirrigated). The codes, which are used for processing the policies and are first applied by the agents, were not standard and caused unnecessary confusion and work for agents, companies, and FCIC.

20. As of December 1996, the transition to a common insurance policy is either complete or in process for 39 of 42 crops. Use of a common policy will simplify the companies' paperwork burden by reducing the number of different forms and will also reduce confusion by eliminating minor policy differences between crops.

21. FCIC expanded the companies' authority to approve master yields. This somewhat complex part of the process for establishing the insurance guarantee on certain crops was previously performed by the Risk Management Agency's Regional Service Offices and required considerable time for communications between the companies and the regional service offices.

22. FCIC changed the T-yield procedure to a simple average across acres instead of the complex weighting system previously used. This change simplified the analysis performed by agents and data processing by companies.

23. FCIC extended the requirement to verify acreage on perennial crops from annually to once every 5 years. Since planted acreage for trees and vines does not vary greatly from year to year, the old requirement was unnecessarily burdensome.

24. FCIC provided producers' production history, crop and acreage data, and other pertinent data on its limited access server to facilitate the transfer of policyholder data to assuming companies during the transition of catastrophic insurance to single delivery in the 14 states where single delivery was authorized.

25. FCIC made it easier for participating companies to check producers' status in the Non-standard Classification System by making this information available electronically. FCIC uses the Non-standard Classification System to adjust the rate or guarantee of individual farmers whose historical experience is significantly worse than other farmers in the same area. Current Non-standard Classification System data are important to companies in accurately underwriting and assigning risk to some farmers.

26. FCIC implemented an option whereby farmers could opt out, or exclude, hail and fire coverage for multiple years with a single application. Previously, farmers had to apply annually for this exclusion and submit data about the replacement coverage that they purchased from a private insurer.

Simplification Actions in Progress

1. FCIC is working to automate the issuance and reporting of written individualized endorsement agreements. This change could reduce the time required for processing these agreements—about 4,000 a year—by 2 to 4 weeks.
2. FCIC is automating the funding of reinsurance escrow accounts for the 1997 reinsurance year, which will provide funds to companies sooner. This funding allows reinsured companies to be reimbursed for paid losses either on the same day that claims data are submitted or the next day.
3. FCIC is automating the list of farmers who have been declared ineligible for crop insurance and to whom the participating companies are prohibited from selling policies. Easier access to these data will reduce errors and time.
4. FCIC is in the process of reviewing the quality-control requirements imposed in FCIC's Manual 14 to identify and eliminate redundant or unnecessary requirements, such as overlapping and duplicative reviews or inspections and outdated procedures and policies.
5. Using data from USDA's National Agricultural Statistics Service, FCIC is developing proxy-yield substitutes for the current T-yield system. This change will address program complaints from companies, provide greater flexibility, and fill the gap in the crop insurance program when actual records are not submitted.
6. Simplified actual production history and added-land procedures are being developed to reduce the number of individual unit databases maintained by companies.
7. FCIC is currently developing a system to quote provisional prices to farmers. With this type of system, FCIC can issue actuarial tables earlier so that farmers can purchase coverage for at least a minimum price, knowing that the market price, which is announced later, may be higher. This

change will enable companies to begin using actuarial data much sooner and to spread work out over a greater period.

8. FCIC is reviewing the timing of reports on fees collected from farmers to determine the feasibility of less frequent reporting. The current administrative effort required to collect and account for the \$50 and \$10 fees seems to be excessive for the companies and for FCIC.

9. FCIC is reviewing the timing of the reconciliation of minor accounting errors on the companies' reports to determine the feasibility of less frequent reporting. The current, monthly requirement may impose too great a burden for the sums involved.

10. FCIC is reviewing the feasibility of an automatic all-county insurance option. This change, if implemented, would benefit farmers by automatically providing coverage in cases where farmers decide after the sales closing date to plant an insured crop in a county in which they had not intended to plant and for which they had not purchased insurance.

11. FCIC is adjusting the insurance period for the Texas Citrus Tree program to make the crop year and the reinsurance year coincide. This will eliminate the need for manual accounting and data processing adjustments that are required to move the business from one year to another.

Companies Included in Expense Review

FCIC had standard reinsurance agreements with 22 companies in 1994 and 19 companies in 1995 to sell and service federal crop insurance. In performing our review, we reviewed nine managing general agencies that each managed the business for one or more standard reinsurance agreement holders—those insurance companies responsible for the standard reinsurance agreement—representing about 85 percent of the total federal crop insurance premiums written by private companies in 1994 and 1995 combined. We made our selection of companies considering factors such as premium volume, location, and type of ownership. As a result of business acquisitions and changing business relationships in 1994 and 1995, our review included 12 standard reinsurance agreement holders for 1994 and 12 for 1995. Tables II.1 and II.2 list the companies included in our review for 1994 and 1995, respectively, showing the name of the managing general agency, the location of the managing general agency, and the standard reinsurance agreement holder.

Table II.1: Companies Included in 1994 Review

Managing general agency	Location	Standard reinsurance agreement holder
American Agrisurance	Council Bluffs, Iowa	Redland Insurance Company, Insurance Company of the Prairie States
Blakely Crop Hail, Inc.	Topeka, Kansas	Farmers Alliance Mutual Insurance Company
Cotton States Mutual Insurance Company	Atlanta, Georgia	Cotton States Mutual Insurance Company
Country Mutual Insurance Company	Bloomington, Illinois	Country Mutual Insurance Company
Crop Growers Corporation	Great Falls, Montana	Cimarron Insurance Company, Continental Insurance Company
IGF Insurance Company	Des Moines, Iowa	IGF Insurance Company
National Ag Underwriters, Inc.	Anoka, Minnesota	NAU Insurance Company
Producers Lloyds Insurance Company	Amarillo, Texas	Producers Lloyds Insurance Company
Rain and Hail Insurance Services, Inc.	West Des Moines, Iowa	CIGNA Property and Casualty Insurance Company, Columbia Mutual Insurance Company

Source: GAO's analysis of FCIC's data.

Appendix II
Companies Included in Expense Review

Table II.2: Companies Included in 1995 Review

Managing general agency	Location	Standard reinsurance agreement holder
American Agrisurance	Council Bluffs, Iowa	Redland Insurance Company
Blakely Crop Hail, Inc.	Topeka, Kansas	Farmers Alliance Mutual Insurance Company
Cotton States Mutual Insurance Company	Atlanta, Georgia	Cotton States Mutual Insurance Company
Country Mutual Insurance Company	Bloomington, Illinois	Country Mutual Insurance Company
Crop Growers Corporation	Great Falls, Montana	Continental Insurance Company, Dawson Hail Insurance Company, Plains Insurance Company
IGF Insurance Company	Des Moines, Iowa	IGF Insurance Company, PAFCO General Insurance Company
Producers Lloyds Insurance Company	Amarillo, Texas	Producers Lloyds Insurance Company
Rain and Hail Insurance Services, Inc.	West Des Moines, Iowa	CIGNA Property and Casualty Insurance Company
Rural Community Insurance Services	Anoka, Minnesota	Rural Community Insurance Company

Source: GAO's analysis of FCIC's data.

Summary of Adjustments Made to Reported Expenses of Nine Companies, 1994-95

For the nine companies included in our review, we evaluated their reported expenses to determine whether the reported expenses seemed reasonable for the sale and service of federal crop insurance. Generally, we considered as reasonable those expenses associated with (1) interacting with farmers, (2) reviewing insured property, (3) processing policy and claims paperwork, and (4) related overhead and indirect costs, including the training and travel of staff. In order to develop a consistent measure of delivery expenses across the industry, we deducted reported expenses that appeared unreasonable for the delivery of crop insurance.

We categorized adjustments to the companies' reported crop insurance expenses into 19 areas, as shown in table III.1. Amounts in parenthesis represent deductions from the companies' reported expenses; other amounts are additions to the companies' reported expenses. For 1994, the nine companies reported expenses of \$236.8 million for selling and servicing buyup insurance. Our review identified adjustments of \$27.2 million for expenses that did not appear to be reasonably associated with the sale and service of crop insurance. For 1995, the nine companies reported expenses of \$305.5 million related to buyup and catastrophic insurance. Our review of these reported expenses identified adjustments of \$15.9 million. The percent of premium calculations in table III.1 are based on 1994 premiums of \$763.4 million and 1995 catastrophic and buyup combined premiums of \$1.1 billion for the nine companies. Following table III.1 is a brief explanation of each adjustment category.

Appendix III
Summary of Adjustments Made to Reported
Expenses of Nine Companies, 1994-95

Table III.1: Summary of Adjustments Made to Reported Expenses of Nine Companies, 1994-95

Type of adjustment	1994		1995	
	Amount	Percent of premium	Amount	Percent of premium
1. Extraordinary write-offs	(\$4,218,984)	(0.55)	(\$51,532)	(0.00)
2. Payments for purchased intangible assets	(3,329,976)	(0.44)	(2,879,096)	(0.26)
3. Payments for non-compete contracts	(806,932)	(0.11)	(730,632)	(0.07)
4. Premiums paid for commercial reinsurance	(5,415,638)	(0.71)	(5,321,977)	(0.49)
5. Bonuses tied to company profitability	(4,363,099)	(0.57)	(6,750,674)	(0.62)
6. State income taxes and tax penalties	(483,929)	(0.06)	(1,297,906)	(0.12)
7. Expenses not capitalized	0	0.00	(2,400,000)	(0.22)
8. Fronting fees with no measurable benefit	(1,162,314)	(0.15)	(1,533,513)	(0.14)
9. Loss-adjusting expenses not tied to correct year	(114,724)	(0.02)	495,100	0.05
10. Crop-hail expenses	(111,157)	(0.01)	(59,443)	(0.01)
11. Miscalculated and omitted expenses	(4,870,931)	(0.64)	6,949,340	0.63
12. Offsetting related income against reported expense items	(1,208,465)	(0.16)	(1,188,036)	(0.11)
13. Parent company management fees with no measurable benefit	(618,217)	(0.08)	(486,600)	(0.04)
14. Prior year expenses	(20,000)	(0.00)	0	0.00
15. Lobbying and related expenses	(113,585)	(0.01)	(304,809)	(0.03)
16. Interest paid on late paid premiums to FCIC	(611,260)	(0.08)	(38,996)	(0.00)
17. Claim overpayments/adjustments due to company error	258,789	0.03	(298,891)	(0.03)
18. Personal and/or family expenses	(701)	(0.00)	(1,846)	(0.00)
19. Undocumented expenses	(31,467)	(0.00)	0	0.00
Total adjustments	(\$27,222,590)	(3.57)	(\$15,899,511)	(1.45)

Note: Amounts in parenthesis were subtracted from reported expenses.

Source: GAO's analysis of nine participating companies' data.

The following is a brief explanation of each numbered adjustment category.

1. **Extraordinary write-offs** are one-time expenses relating to the purchase of another company's business. These charges included liabilities unforeseen at the time of purchase.

2. **Payments for purchased intangible assets** are payments for the purchase of another company's business above its book value, commonly called goodwill.

3. **Payments for non-compete contracts** are payments to individuals as compensation for not competing in the crop insurance industry for a specified period of time. Typically, such payments are in conjunction with the purchase of one company by another company.

4. **Premiums paid for commercial reinsurance** are premiums paid by an insurance company to another company to (1) reduce its risk of underwriting loss and (2) increase its capacity to write more insurance than otherwise allowed by its own surplus. This type of expense should be paid from the company's underwriting results and is not associated with the direct sale and service of federal crop insurance to farmers.

5. **Bonuses tied to company profitability** are company earnings from selling and servicing crop insurance distributed as bonuses and reported as a necessary delivery expense. The administrative expense reimbursement is intended to reimburse participating companies only for expenses that can be reasonably associated with selling and servicing crop insurance, not provide a profit. Underwriting is intended to provide companies with the potential to earn profits.

6. **State income taxes and tax penalties** are state taxes paid on profits resulting from the delivery and the underwriting of crop insurance and expenses related to tax penalties. These expenses should be paid from underwriting results.

7. **Expenses not capitalized** are expenses of capital assets charged-off in the period acquired. Generally accepted accounting principles require that such costs be amortized over the useful life of the asset. We applied an appropriate depreciation method for the type of asset in question and recognized as an expense a portion of the asset's cost for the period of our review.

8. **Fronting fees with no measurable benefit** are fees paid to another company, explicitly for service or support of crop insurance, but at a rate that is above the industry average and for which no measurable benefit from this higher rate could be identified. While this may be a necessary expense of selling and servicing crop insurance in some circumstances, we deducted seemingly high charges for which there was no identifiable benefit to the purchasing company or the government.

9. **Loss-adjusting expenses not tied to correct year** are both additions and subtractions to a company's loss-adjusting expenses to adjust some expenses reported on a calendar year basis to a reinsurance year basis.

10. **Crop-hail expenses** are expenses directly and indirectly related to the sale and service of private crop-hail insurance but reported as expenses related to the sale and service of federal crop insurance.

11. **Miscalculated and omitted expenses** are various amounts that were either calculated in error or, although associated with the sale and service of crop insurance, not reported.

12. **Offsetting related income against reported expense items** are reductions to expense accounts in an amount equal to related income accounts. For example, we reduced reported interest expenses by offsetting, unreported interest income; we reduced automobile expenses by offsetting personal mileage reimbursements paid to the company; and we reduced legal expenses by the amount of related legal expense reimbursements received from FCIC. Generally accepted accounting principles require a matching of income and expense items.

13. **Parent company management fees with no measurable benefit** are various fees assessed by parent companies to subsidiary crop insurance companies and reported as crop insurance delivery expenses, but for which no measurable benefit to the federal crop insurance program could be identified.

14. **Prior year expenses** are payments for 1993 premium taxes and other prior year commission expenses that should not be included in 1994 and 1995 expenses.

15. **Lobbying and related expenses** are payments to industry trade associations for lobbying activities precluded by FCIC's standard reinsurance agreement.

16. **Interest paid for late paid premiums to FCIC** are interest payments made to FCIC or others to borrow money to pay FCIC for premiums due. While these were reported by some companies as an expense of selling and servicing crop insurance, they were not a necessary expense but reflect companies' operating decisions, including decisions about working capital levels.

17. **Claim overpayments/adjustments due to company error** are claim overpayments made as a result of company oversight but charged as a crop insurance delivery expense.

18. **Personal and/or family expenses** are personal and family expenses, such as clothing and airline tickets, erroneously reported as crop insurance delivery expenses.

19. **Undocumented expenses** are expenses reported as crop insurance expenses for which no supporting documentation could be found.

Crop Insurance Companies' Expenses for Selling and Servicing Crop Insurance

The tables in this appendix show the expenses for selling and servicing federal crop insurance as reported by the nine companies in our review and as adjusted to reflect the expenses reasonably associated with the sale and service of federal crop insurance. Table IV.1 shows the company-reported and GAO-adjusted expenses for 1994. Table IV.2 shows the percent of premium, dollars per policy, and dollars per unit with premium for the GAO-adjusted expenses for 1994. Table IV.3 shows company-reported and GAO-adjusted expenses for 1995. Since the companies reported combined expenses and did not separate expenses for catastrophic and buyup insurance, table IV.4 shows GAO-adjusted expenses for catastrophic insurance for 1995, based on a proration of total adjusted expenses using units with a claim payment, policies with premium, and premium volume ratios. Table IV.5 shows GAO-adjusted expenses for buyup insurance for 1995, based on similar prorations. The difference between reported and adjusted expense figures in these tables are the adjustments we made, as explained in appendix III. Premiums, policies with premium, units with premium, and units with a claim payment for the nine companies in our review for 1994 and 1995 are shown in table IV.6.

Table IV.1: Company-Reported and GAO-Adjusted Expenses for Selling and Servicing Federal Crop Insurance, 1994

Operating expense classifications	Company-reported total expenses	GAO-adjusted total expenses
1. Claim adjustment services		
Direct	\$24,460,403	\$24,463,848
Reinsurance assumed	(180)	0
Less: reinsurance ceded	0	0
Net claim adjustment services	\$24,460,223	\$24,463,848
2. Commission and brokerage		
Direct excluding contingent	\$129,226,151	\$121,200,911
Reinsurance assumed excluding contingent	1,166,759	193,759
Less: reinsurance ceded excluding contingent	0	0
Contingent — direct	935,080	788,637
Contingent — reinsurance assumed	0	0
Less: contingent — reinsurance ceded	0	0
Policy and membership fees	0	0
Net commission and brokerage	\$131,327,990	\$122,183,307
Lines 3-17. General operating expenses		
3. Allowances to managers and agents	\$184,274	\$5,006,101
4. Advertising	848,569	873,918
5. Boards, bureaus and associations	1,882,252	1,871,932

(continued)

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Operating expense classifications	Company-reported total expenses	GAO-adjusted total expenses
6. Surveys and underwriting reports	69,390	90,255
7. Audit of assureds' records	18,033	18,030
8. Salary-related items:		
Salaries	28,035,230	25,749,033
Payroll taxes	1,973,329	1,710,273
9. Employee relations and welfare	3,248,618	3,745,063
10. Insurance	729,616	830,871
11. Director's fees	26,200	34,724
12. Travel and travel items	4,220,388	4,160,899
13. Rent and rent items	2,918,090	3,159,992
14. Equipment	3,078,328	3,170,820
15. Printing and stationery	2,585,875	2,816,230
16. Postage, telephone and telegraph, exchange and express	3,813,519	3,962,573
17. Legal and auditing	2,107,965	2,014,607
Subtotal of lines 3-17	\$55,739,676	\$59,215,321
18. Taxes, licenses and fees		
State and local insurance taxes deducting guaranty association credits of \$	\$23,134	\$3,134
Insurance department licenses and fees	316,266	315,534
Gross guaranty association assessments	0	0
All other (excluding federal & foreign income and real estate)	528,252	116,771
Total taxes, licenses and fees	\$867,652	\$435,439
19. Real estate expenses	\$67,369	\$0
20. Real estate taxes	\$62,481	\$0
21. Aggregate write-ins for miscellaneous operating expenses	\$24,296,372	\$3,301,257
22. Total expenses	\$236,821,763	\$209,599,172

Source: GAO's analysis of nine companies' data.

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Table IV.2: GAO-Adjusted Expenses for Selling and Servicing Federal Crop Insurance, 1994, as a Percent of Premium and in Terms of Dollars Per Policy and Dollars Per Unit

Operating expense classifications	GAO-adjusted expenses	Percent of premium	Dollars per policy	Dollars per unit with premium
1. Claim adjustment services				
Direct	\$24,463,848	3.2	\$58.63	\$15.64
Reinsurance assumed	0	0	0.00	0.00
Less: reinsurance ceded	0	0.0	0.00	0.00
Net claim adjustment services^a	\$24,463,848	3.2	\$58.63	\$15.64
2. Commission and brokerage				
Direct excluding contingent	\$121,200,911	15.9	\$290.48	\$77.49
Reinsurance assumed excluding contingent	193,759	0.0	0.46	0.12
Less: reinsurance ceded excluding contingent	0	0.0	0.00	0.00
Contingent — direct	788,637	0.1	1.89	0.50
Contingent — reinsurance assumed	0	0	0.00	0.00
Less: contingent — reinsurance ceded	0	0.0	0.00	0.00
Policy and membership fees	0	0	0.00	0.00
Net commission and brokerage	\$122,183,307	16.0	\$292.84	\$78.12
Lines 3-17. General operating expenses				
3. Allowances to managers and agents	\$5,006,101	0.7	\$12.00	\$3.20
4. Advertising	873,918	0.1	2.09	0.56
5. Boards, bureaus and associations	1,871,932	0.2	4.49	1.20
6. Surveys and underwriting reports	90,255	0.0	0.22	0.06
7. Audit of assureds' records	18,030	0.0	0.04	0.01
8. Salary-related items:				
Salaries	25,749,033	3.4	61.71	16.46
Payroll taxes	1,710,273	0.2	4.10	1.09
9. Employee relations and welfare	3,745,063	0.5	8.98	2.39
10. Insurance	830,871	0.1	1.99	0.53
11. Director's fees	34,724	0.0	0.08	0.02
12. Travel and travel items	4,160,899	0.5	9.97	2.66
13. Rent and rent items	3,159,992	0.4	7.57	2.02
14. Equipment	3,170,820	0.4	7.60	2.03
15. Printing and stationery	2,816,230	0.4	6.75	1.80
16. Postage, telephone and telegraph, exchange and express	3,962,573	0.5	9.50	2.53
17. Legal and auditing	2,014,607	0.3	4.83	1.29
Subtotal of lines 3-17	\$59,215,321	7.8	\$141.92	\$37.86
18. Taxes, licenses and fees				

(continued)

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Operating expense classifications	GAO-adjusted expenses	Percent of premium	Dollars per policy	Dollars per unit with premium
State and local insurance taxes deducting guaranty association credits of \$	\$3,134	0.0	\$0.01	\$0.00
Insurance department licenses and fees	315,534	0.0	0.76	0.20
Gross guaranty association assessments	0	0.0	0.00	0.00
All other (excluding federal & foreign income and real estate)	116,771	0.0	0.28	0.07
Total taxes, licenses and fees	\$435,439	0.1	\$1.04	\$0.28
19. Real estate expenses	\$0	0.0	\$0.00	\$0.00
20. Real estate taxes	\$0	0.0	\$0.00	\$0.00
21. Aggregate write-ins for miscellaneous operating expenses	\$3,301,257	0.4	\$7.91	\$2.11
22. Total expenses	\$209,599,172	27.5	\$502.35	\$134.01

^aNet claim adjustment services were \$141.13 per unit with a claim payment.

Source: GAO's analysis of FCIC's and nine companies' data.

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Table IV.3: Company-Reported and GAO-Adjusted Expenses for Selling and Servicing Federal Crop Insurance, 1995^a

Operating expense classifications	Company-reported total expenses	GAO-adjusted total expenses
1. Claim adjustment services		
Direct	\$33,298,853	\$36,880,112
Reinsurance assumed	0	0
Less: reinsurance ceded	0	0
Net claim adjustment services	\$33,298,853	\$36,880,112
2. Commission and brokerage		
Direct excluding contingent	\$160,218,937	\$155,817,956
Reinsurance assumed excluding contingent	597,277	155,857
Less: reinsurance ceded excluding contingent	2,636,000	0
Contingent — direct	1,070,325	1,568,212
Contingent — reinsurance assumed	0	0
Less: contingent — reinsurance ceded	0	0
Policy and membership fees	0	0
Net commission and brokerage	\$159,250,539	\$157,542,025
Lines 3-17. General operating expenses		
3. Allowances to managers and agents	\$2,911,220	\$6,126,462
4. Advertising	1,194,318	1,232,376
5. Boards, bureaus and associations	2,844,774	2,945,358
6. Surveys and underwriting reports	110,993	168,270
7. Audit of assureds' records	20,344	20,344
8. Salary-related items:		
Salaries	41,837,055	37,633,413
Payroll taxes	3,718,427	3,808,615
9. Employee relations and welfare	4,032,784	5,524,937
10. Insurance	938,831	967,129
11. Director's fees	37,169	56,251
12. Travel and travel items	6,344,078	6,585,353
13. Rent and rent items	3,798,264	4,192,367
14. Equipment	4,037,347	4,453,554
15. Printing and stationery	4,943,435	5,409,392
16. Postage, telephone and telegraph, exchange and express	5,720,936	6,243,747
17. Legal and auditing	2,823,371	2,896,073
Subtotal of lines 3-17	\$85,313,346	\$88,263,642
18. Taxes, licenses and fees		
State and local insurance taxes deducting guaranty association credits of \$	\$259,637	\$205,137

(continued)

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Operating expense classifications	Company-reported total expenses	GAO-adjusted total expenses
Insurance department licenses and fees	576,373	576,373
Gross guaranty association assessments	0	0
All other (excluding federal & foreign income and real estate)	1,304,293	60,955
Total taxes, licenses and fees	\$2,140,303	\$842,465
19. Real estate expenses	\$611,554	\$496,081
20. Real estate taxes	\$65,884	\$50,000
21. Aggregate write-ins for miscellaneous operating expenses	\$24,787,168	\$5,493,812
22. Total expenses	\$305,467,647	\$289,568,136

^aThese numbers are for catastrophic and buyup insurance combined.

Source: GAO's analysis of nine companies' data.

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Table IV.4: GAO-Adjusted Expenses for Catastrophic Insurance, 1995, as a Percent of Premium and in Terms of Dollars Per Policy and Dollars Per Unit

Operating expense classifications	GAO-adjusted catastrophic expenses ^a	Percent of premium	Dollars per policy	Dollars per unit with premium
1. Claim adjustment services				
Direct	\$3,357,617	2.1	\$16.84	\$7.50
Reinsurance assumed	0	0.0	0.00	0.00
Less: reinsurance ceded	0	0.0	0.00	0.00
Net claim adjustment services^b	\$3,357,617	2.1	\$16.84	\$7.50
2. Commission and brokerage				
Direct excluding contingent	\$6,053,764	3.8	\$30.37	\$13.52
Reinsurance assumed excluding contingent	0	0.0	0.00	0.00
Less: reinsurance ceded excluding contingent	0	0.0	0.00	0.00
Contingent — direct	0	0.0	0.00	0.00
Contingent — reinsurance assumed	0	0.0	0.00	0.00
Less: contingent — reinsurance ceded	0	0.0	0.00	0.00
Policy and membership fees	0	0.0	0.00	0.00
Net commission and brokerage	\$6,053,764	3.8	\$30.37	\$13.52
Lines 3-17. General operating expenses				
3. Allowances to managers and agents	\$599,412	0.4	\$3.01	\$1.34
4. Advertising	346,600	0.2	1.74	0.77
5. Boards, bureaus and associations	853,669	0.5	4.28	1.91
6. Surveys and underwriting reports	35,309	0.0	0.18	0.08
7. Audit of assureds' records	6,156	0.0	0.03	0.01
8. Salary-related items:				
Salaries	10,980,358	7.0	55.09	24.53
Payroll taxes	1,203,287	0.8	6.04	2.69
9. Employee relations and welfare	1,491,037	0.9	7.48	3.33
10. Insurance	325,858	0.2	1.63	0.73
11. Director's fees	11,912	0.0	0.06	0.03
12. Travel and travel items	2,054,867	1.3	10.31	4.59
13. Rent and rent items	1,161,849	0.7	5.83	2.60
14. Equipment	1,165,806	0.7	5.85	2.60
15. Printing and stationery	1,699,309	1.1	8.52	3.80
16. Postage, telephone and telegraph, exchange and express	1,861,310	1.2	9.34	4.16
17. Legal and auditing	816,076	0.5	4.09	1.82
Subtotal of lines 3-17	\$24,612,816	15.6	\$123.48	\$54.98
18. Taxes, licenses and fees				

(continued)

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Operating expense classifications	GAO-adjusted catastrophic expenses^a	Percent of premium	Dollars per policy	Dollars per unit with premium
State and local insurance taxes deducting guaranty association credits of \$	\$76,683	0.0	\$0.38	\$0.17
Insurance department licenses and fees	174,781	0.1	0.88	0.39
Gross guaranty association assessments	0	0.0	0.00	0.00
All other (excluding federal & foreign income and real estate)	21,922	0.0	0.11	0.05
Total taxes, licenses and fees	\$273,386	0.2	\$1.37	\$0.61
19. Real estate expenses	\$184,262	0.1	\$0.92	\$0.41
20. Real estate taxes	\$18,572	0.0	\$0.09	\$0.04
21. Aggregate write-ins for miscellaneous operating expenses	\$520,179	0.3	\$2.61	\$1.16
22. Total expenses	\$35,020,595	22.2	\$175.69	\$78.23

^aThese numbers are based on a proration of the adjusted combined total amounts shown in table IV.3. Loss adjusting expenses are prorated between catastrophic and buyup insurance based on units indemnified—units with a claim payment. Most commission expenses are prorated directly between catastrophic and buyup insurance; some are prorated based on premiums. Line 3 expenses are prorated between catastrophic and buyup insurance based on premiums. All other expenses are prorated between catastrophic and buyup insurance based on the number of policies with premiums. See table IV.6 for unit, policy, and premium data used.

^bNet claim adjustment services were \$91.37 per unit with a claim payment.

Source: GAO's analysis of FCIC's and nine companies' data.

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Table IV.5: GAO-Adjusted Expenses for Buyup Insurance, 1995, as a Percent of Premium and in Terms of Dollars Per Policy and Dollars Per Unit

Operating expense classifications	GAO-adjusted buyup expenses ^a	Percent of premium	Dollars per policy	Dollars per unit with premium
1. Claim adjustment services				
Direct	\$33,522,495	3.6	\$73.07	\$20.23
Reinsurance assumed	0	0.0	0.00	0.00
Less: reinsurance ceded	0	0.0	0.00	0.00
Net claim adjustment services^b	\$33,522,495	3.6	\$73.07	\$20.23
2. Commission and brokerage				
Direct excluding contingent	\$149,764,192	16.0	\$326.45	\$90.40
Reinsurance assumed excluding contingent	155,857	0.0	0.34	0.09
Less: reinsurance ceded excluding contingent	0	0.0	0.00	0.00
Contingent — direct	1,568,212	0.2	3.42	0.95
Contingent — reinsurance assumed	0	0.0	0.00	0.00
Less: contingent — reinsurance ceded	0	0.0	0.00	0.00
Policy and membership fees	0	0.0	0.00	0.00
Net commission and brokerage	\$151,488,261	16.2	\$330.21	\$91.44
Lines 3-17. General operating expenses				
3. Allowances to managers and agents	\$5,527,050	0.6	\$12.05	\$3.34
4. Advertising	885,776	0.1	1.93	0.53
5. Boards, bureaus and associations	2,091,689	0.2	4.56	1.26
6. Surveys and underwriting reports	132,961	0.0	0.29	0.08
7. Audit of assureds' records	14,188	0.0	0.03	0.01
8. Salary-related items:				
Salaries	26,653,055	2.8	58.10	16.09
Payroll taxes	2,605,328	0.3	5.68	1.57
9. Employee relations and welfare	4,033,900	0.4	8.79	2.43
10. Insurance	641,271	0.1	1.40	0.39
11. Director's fees	44,339	0.0	0.10	0.03
12. Travel and travel items	4,530,486	0.5	9.88	2.73
13. Rent and rent items	3,030,518	0.3	6.61	1.83
14. Equipment	3,287,748	0.4	7.17	1.98
15. Printing and stationery	3,710,083	0.4	8.09	2.24
16. Postage, telephone and telegraph, exchange and express	4,382,437	0.5	9.55	2.65
17. Legal and auditing	2,079,997	0.2	4.53	1.26
Subtotal of lines 3-17	\$63,650,826	6.8	\$138.75	\$38.42
18. Taxes, licenses and fees				

(continued)

Appendix IV
Crop Insurance Companies' Expenses for
Selling and Servicing Crop Insurance

Operating expense classifications	GAO-adjusted buyup expenses^a	Percent of premium	Dollars per policy	Dollars per unit with premium
State and local insurance taxes deducting guaranty association credits of \$	\$128,454	0.0	\$0.28	\$0.08
Insurance department licenses and fees	401,592	0.0	0.88	0.24
Gross guaranty association assessments	0	0.0	0.00	0.00
All other (excluding federal & foreign income and real estate)	39,033	0.0	0.09	0.02
Total taxes, licenses and fees	\$569,079	0.1	\$1.24	0.34
19. Real estate expenses	\$311,819	0.0	\$0.68	0.19
20. Real estate taxes	\$31,428	0.0	\$0.07	\$0.02
21. Aggregate write-ins for miscellaneous operating expenses	\$4,973,633	0.5	\$10.84	\$3.00
22. Total expenses	\$254,547,541	27.1	\$554.86	\$153.65

^aThese numbers are based on a proration of the adjusted combined total amounts shown in table IV.3. Loss adjusting expenses are prorated between catastrophic and buyup insurance based on units indemnified—units with a claim payment. Most commission expenses are prorated directly between catastrophic and buyup insurance; some are prorated based on premiums. Line 3 expenses are prorated between catastrophic and buyup insurance based on premiums. All other expenses are prorated between catastrophic and buyup insurance based on the number of policies with premiums. See table IV.6 for unit, policy, and premium data used.

^bNet claim adjustment services were \$87.08 per unit with a claim payment.

Source: GAO's analysis of FCIC's and nine companies' data.

Table IV.6: Summary of Federal Crop Insurance Activity for the Nine Companies in Our Expense Review

Data for nine companies combined	1994	1995 Combined catastrophic and buyup	1995 Catastrophic only	1995 Buyup only
Premiums	\$763,400,148	\$1,095,309,588	\$157,580,729	\$937,728,859
Policies with premium	417,239	658,094	199,333	458,761
Units with premium	1,564,071	2,104,302	447,634	1,656,668
Units with a claim payment	173,339	421,698	36,746	384,952

Source: GAO's analysis of FCIC's data.

Methodology for Comparing 1995 Cost to Government to Deliver Catastrophic Insurance Through USDA and Private Companies

The government sells and services catastrophic crop insurance through USDA as well as through private companies. Table V.1 provides an analysis of the government's costs to deliver catastrophic insurance through USDA in 1995. Table V.2 provides an analysis of the government's costs to deliver catastrophic insurance through private companies in 1995. Unlike our evaluation of companies' expenses to sell and service crop insurance, this analysis is a comparison of costs to the government to deliver catastrophic insurance through two different delivery systems. This analysis compares the total costs to the government to deliver catastrophic insurance through USDA and private companies, including all private companies, not only the ones in our review. Below is an explanation of our methodology for determining the government's costs for each delivery system.

Methodology for Determining the Cost to the Government to Deliver Catastrophic Insurance Through USDA in 1995

To determine the cost to the government for USDA's delivery of catastrophic crop insurance, we identified and summed all applicable expenses paid with government funds. We then reduced these expenses by the amount of processing fees paid by farmers and collected by USDA's local Farm Service Agency (FSA) offices. The government's basic costs to deliver catastrophic insurance through USDA in 1995 were the costs that USDA incurred to sell and service catastrophic crop insurance policies. The majority of these costs consisted of direct and indirect expenses incurred by FSA's local offices. USDA also incurred other direct and indirect costs for software development, central staff support, and FCIC support. Offsetting these expenses were the amount of catastrophic insurance processing fees collected from farmers by FSA's offices and remitted to USDA, thereby reducing USDA's overall delivery expenses and the costs to the government. See table V.1.

We identified the costs incurred by FSA's local offices to deliver catastrophic insurance using USDA's County Office Work Measurement and Fund Allocation System for 1995. This system is used to track the amount of time in staff work days required to perform identified elements of work performed in local county offices which is then multiplied by an average cost per staff work day that includes salaries and benefits. With assistance from USDA, we selected all work items that related directly or indirectly to the delivery of catastrophic insurance. Those work items that were directly related to catastrophic insurance delivery are listed in table V.1 with their respective work item codes, for example, "225 Signup for catastrophic program" and "9092 Photocopies." We computed direct costs for FSA's local offices to be \$45,965,217.

For those work items that were indirectly related, such as general administration of USDA's County Office Work Measurement and Fund Allocation System, rent, and utilities, we included a prorated amount based on the relationship between the total cost of the direct catastrophic insurance delivery work items of \$45,965,217 to the total cost of all direct work items in the system of \$281,621,066, or about 16.3 percent. We applied this percentage to the total for overhead work items of \$202,393,699 to determine the overhead costs of FSA's local offices of \$33,034,000.

Other costs incurred by the government to deliver catastrophic insurance through USDA included direct and indirect costs for FSA's software development and support staff, and FCIC's support. According to FSA, it expended about 10,163 work hours for software development between June 1, 1994, and December 31, 1995. FSA estimated an average software development cost, including salaries and benefits, of \$32 per hour for a total of \$325,208. In addition, FSA incurred costs for central staff support¹ in its Washington, D.C., state, and area offices of \$8,007,249. This total included direct salary, travel, printing, and other costs amounting to \$7,129,169; and estimated indirect support costs of \$878,080. FCIC's support costs for salaries, computer resources, training, travel, public awareness, loss adjusting, and other miscellaneous costs amounted to \$19,303,489. The total we computed for direct and indirect costs of \$78,999,217 for FSA's local offices plus the total direct and indirect costs for FSA's software development, FSA's support staff, and FCIC's support of \$27,635,946 equals the total basic cost to the government to deliver catastrophic insurance through USDA in 1995 of \$106,635,163, or \$132.72 per crop policy.

FSA's local offices collected \$42,822,950 in processing fees from farmers. This directly reduced the cost to the government to deliver catastrophic insurance through USDA because these dollars were remitted to USDA. Accordingly, the total cost to the government of USDA's delivery was \$63,812,213, or \$79.42 per crop policy.

¹In 1995, these staff were part of USDA's Agricultural Stabilization and Conservation Service.

**Methodology for
Determining the Cost to
the Government to Deliver
Catastrophic Insurance
Through Companies in
1995**

To determine the cost to the government for private companies' delivery of catastrophic insurance, we identified and totaled (1) all government payments to private companies to deliver catastrophic crop insurance and (2) all expenses incurred by FSA's local offices to support private delivery of catastrophic insurance. We also reduced the government's cost for private company delivery by the amount of excess processing fees collected by companies and remitted to USDA. The basic costs to the government to deliver catastrophic insurance through private companies in 1995 consisted of a percentage of premiums reimbursed to companies and various support costs incurred by FSA. Offsetting these expenses were the amount of excess catastrophic insurance processing fees companies collected from farmers and remitted to USDA, thereby slightly reducing the government's cost for company delivery. In addition, USDA paid the companies an underwriting gain in 1995 that was based on the amount of underwriting risk the companies retained. See table V.2.

In 1995, the government paid the companies \$25,882,567 in expense reimbursements for catastrophic policies. This is about 14.8 percent of their written catastrophic insurance premiums of about \$174.9 million.

FSA's local offices provided various support services to private companies in 1995. Costs incurred for this support are tracked using various work item codes in USDA's County Office Work Measurement and Fund Allocation System. With assistance from FSA, we selected each work item relating directly to support services provided to private companies, such as "0210 Information for reinsured companies." We computed total support costs provided by FSA's local offices to be \$3,499,061. Combined with the expense reimbursement of \$25,882,567, the total basic cost to the government to deliver catastrophic insurance through private companies in 1995 was \$29,381,628, or \$83.37 per crop policy.

The Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 authorized companies to retain processing fees collected from farmers up to specified limits per farmer per county.² Fees collected that exceeded these limits had to be remitted to the government. This reduced the basic cost to the government for company delivery by the amount of fees that the companies remitted to the government, or by \$2,543,000. In 1995, USDA also paid companies additional reimbursements totaling \$2,950 for excess loss adjusting. After including excess loss adjusting reimbursements and offsetting income from fees, the

²Participating companies retained \$17,356,400 in catastrophic insurance processing fees collected from farmers.

Appendix V
Methodology for Comparing 1995 Cost to
Government to Deliver Catastrophic
Insurance Through USDA and Private
Companies

government's cost to deliver catastrophic insurance through private companies was \$26,841,578 or \$76.16 per crop policy.

Also, under the 1995 standard reinsurance agreement, companies could share in any underwriting gains or losses resulting from the catastrophic insurance they sold. Since premiums for catastrophic insurance coverage are paid entirely by the government, any underwriting gains—premiums in excess of claims paid out—are premium dollars funded by the government. In 1995, the companies earned an estimated underwriting gain of \$44,777,673. Therefore, in 1995, the cost to the government to deliver catastrophic insurance through companies was increased by this amount of underwriting gain, for a total cost to deliver catastrophic insurance through companies of \$71,619,251, or \$203.22 per crop policy.

To determine costs per crop policy, we obtained from FCIC's Experience database 1995 crop policy counts for catastrophic insurance for each delivery system. According to FCIC's Experience database for 1995, USDA sold 803,438 catastrophic crop policies and the companies sold 352,422 catastrophic crop policies. We then divided the amounts derived for each cost category by these crop policy counts. Although we did not independently assess the accuracy and reliability of USDA's computerized databases, we used the same files USDA uses to manage the crop insurance program and its local county offices.

Table V.1: Cost to the Government to Deliver Catastrophic Insurance Through USDA, 1995

Cost category	Cost	Cost per crop policy	Percent of \$283 million in premiums
FSA local office direct costs—work codes and titles			
225 Signup for catastrophic program	\$19,020,924	\$23.67	6.7
226 Actual production history for insured crops	11,427,774	14.22	4.0
227 Refund of catastrophic processing fees	367,096	0.46	0.1
228 Claim for indemnity	1,501,256	1.87	0.5
229 Acreage report	6,757,722	8.41	2.4
230 Indemnity payment assignment	17,540	0.02	0.0 ^a
231 Critical loss appraisals	1,812,832	2.26	0.6
9092 Photocopies	963,255	1.20	0.3
9093 Aerial photocopies	409,583	0.51	0.1
9115 Reform training travel costs	2,679,690	3.34	0.9
9116 Reform postage costs ^b	1,007,545	1.25	0.4
Subtotal of FSA local office direct costs	\$45,965,217	\$57.21	16.2

(continued)

Appendix V
Methodology for Comparing 1995 Cost to
Government to Deliver Catastrophic
Insurance Through USDA and Private
Companies

Cost category	Cost	Cost per crop policy	Percent of \$283 million in premiums
FSA local office indirect costs			
Allocation of various overhead work items	\$33,034,000	\$41.12	11.7
Total FSA local office costs^c	\$78,999,217	\$98.33	27.9
Other direct and indirect USDA costs:			
FSA direct central software development	\$325,208	\$0.40	0.1
FSA central staff support—direct costs	7,129,169	8.87	2.5
FSA central staff support—indirect costs	878,080	1.09	0.3
Subtotal FSA central staff support costs	\$8,007,249	\$9.97	2.8
USDA/FCIC direct costs			
Salaries	1,541,635	1.92	0.5
Computer resources	1,899,550	2.36	0.7
Training	20,566	0.03	0.0 ^a
Travel	628,451	0.78	0.2
Public awareness	1,462,610	1.82	0.5
Loss adjustment contractors	7,819,110	9.73	2.8
Miscellaneous	5,931,567	7.38	2.1
Subtotal of USDA/FCIC direct costs	\$19,303,489	\$24.03	6.8
Total of other USDA costs	\$27,635,946	\$34.40	9.8
Total basic delivery cost to government	\$106,635,163	\$132.72	37.7
Less catastrophic fees collected	\$42,822,950	\$53.30	15.1
Subtotal cost to government	\$63,812,213	\$79.42	22.6
Plus underwriting gain	\$0	\$0.00	0.0
Total cost to government^d	\$63,812,213	\$79.42	22.6

Note: Totals may not add because of rounding.

^aLess than 0.1 percent.

^bThis work code benefitted both the USDA and the company delivery systems; thus, we prorated the total amount for this work code for both delivery systems based on total federal crop insurance crop policies.

^cLocal office expenses shown do not reflect indemnity activity that may have occurred in the first quarter of fiscal year 1996. USDA was unable to provide such data.

^dCosts include USDA's one-time start up costs for establishing the USDA delivery system.

Source: GAO's analysis of USDA's data.

Appendix V
Methodology for Comparing 1995 Cost to
Government to Deliver Catastrophic
Insurance Through USDA and Private
Companies

Table V.2: Cost to the Government to Deliver Catastrophic Insurance Through Companies, 1995

Cost category	Cost	Cost per crop policy	Percent of \$174.9 million in premiums
Expense reimbursement	\$25,882,567	\$73.44	14.8
Support services provided by FSA's local offices—work codes and titles			
0210 Information for reinsured companies ^a	\$2,698,827	\$7.66	1.5
9086 Aerial compliance ^a	1,700	0.00 ^b	0.0 ^c
9094 Photocopies provided companies ^a	165,973	0.47	0.1
9095 Aerial photocopies provided companies ^a	147,535	0.42	0.1
9102 Postage costs for companies ^a	43,073	0.12	0.0 ^c
9116 Reform postage costs ^d	441,952	1.25	0.3
Total cost of support services provided by FSA	\$3,499,061	\$9.93	2.0
Total basic delivery cost to government	\$29,381,628	\$83.37	16.8
Less catastrophic fees remitted to the government in excess of limits established by 1994 reform act	\$2,543,000	\$7.22	1.5
Plus excess loss adjusting reimbursement	\$2,950	\$0.01	0.0^c
Subtotal of fees and excess loss adjusting reimbursement	(\$2,540,050)	(\$7.21)	(1.5)
Subtotal cost to government	\$26,841,578	\$76.16	15.4
Plus underwriting gain	\$44,777,673	\$127.06	25.6
Total cost to government	\$71,619,251	\$203.22	41.0

Note: Totals may not add because of rounding.

^aThese work codes benefitted both catastrophic and buyup policies sold by the companies; thus, we prorated the total amount for this work code to include only the amount related to the companies' catastrophic crop policies.

^bLess than \$0.01.

^cLess than 0.1 percent.

^dThis work code benefitted both delivery systems; thus, we first prorated the work code amount to both delivery systems based on total federal crop insurance crop policies and then prorated the companies' amount to include only the amount related to the companies' catastrophic crop policies.

Source: GAO's analysis of USDA's data.

Explanation of Policy and Premium Data Used to Illustrate Alternative Expense Reimbursement Arrangements

Crop insurance policies typically consist of more than one unit being insured per policy, many with different types of coverage on those units. Table VI.1 shows policy counts and premium amounts for the various coverage mixes selected by farmers. Policies with additional coverage represent the largest percentage of both policies and premiums sold by companies, 60.1 and 64.6 percent, respectively.

Table VI.1: 1995 Premiums and Policies by Type of Coverage

Dollars in thousands

Coverage mix on a given policy	Number of policies	Percent of total policies	Total premiums	Percent of total premiums	Premiums by type of coverage			
					Catastrophic	Limited	Additional	Other
Policies sold by companies								
Catastrophic only	186,031	26.2	\$141,648	11.2	\$141,648	\$0	\$0	\$0
Limited additional only	33,352	4.7	65,872	5.2	0	65,872	0	0
Catastrophic and limited additional	4,910	0.7	19,811	1.6	6,212	13,599	0	0
Additional only	427,366	60.1	814,045	64.6	0	0	814,045	0
Catastrophic and additional	41,319	5.8	137,795	10.9	25,037	0	112,759	0
Limited additional and additional	14,704	2.1	61,075	4.8	0	23,473	37,602	0
Catastrophic and limited additional and additional	2,145	0.3	15,127	1.2	1,946	5,466	7,715	0
Other	1,331	0.2	5,235	0.4	7	4	21	5,202
Total federal crop insurance sold by companies	711,158	100.0	\$1,260,609	100.0	\$174,850	\$108,415	\$972,141	\$5,202
Total USDA catastrophic	457,607	100.0	\$282,997	100.0	\$282,979	n/a	n/a	18
Total federal crop insurance sold	1,168,765	100.0	\$1,543,606	100.0	\$457,830	\$108,415	\$972,141	\$5,220

Note: Totals may not add because of rounding.

Source: GAO's analysis of FCIC's data.

GAO-Adjusted Delivery Expenses for Buyup Insurance in Relation to Published Data on Commercial Lines of Insurance

As mandated by the 1994 crop insurance reform act, table VII.1 presents GAO-adjusted delivery expenses for buyup insurance as a percent of premium for 1994 and 1995 as well as the published 10-year average delivery expenses as a percent of premium for various commercial property and casualty lines of insurance. The buyup delivery expenses compared are our adjusted, nine-company total expenses as a percent of buyup premium as shown in appendix IV, table IV.2 for 1994 and table IV.5 for 1995. Property and casualty delivery expenses as a percent of premium are from Best’s Aggregates & Averages: Property-Casualty, 1996 Edition. We did not, however, use this information to arrive at our conclusion of an appropriate reimbursement rate.

As we note in our table, a comparison of companies’ percentage of premium data for various insurance lines may be misleading because the amount of premium dollars involved per policy is not shown. In particular, premiums for some commercial insurance lines are significantly lower than government crop insurance premiums. Consequently, although expenses as a percent of premium may appear to be much higher for several commercial lines, the amount of expense dollars involved per policy is actually less than for government crop insurance.

In addition, the expense ratios for commercial lines are based on premiums that include both risk and expense factors, while the expense ratios for multiple-peril buyup crop insurance are based on the premiums that include only a risk factor. Furthermore, we did not analyze the numbers associated with any commercial lines of insurance, including the factors that determine delivery expenses.

Table VII.1: Delivery Expenses as a Percent of Premium for 1994 and 1995 Adjusted Government Buyup Crop Insurance and Published 10-Year Averages for Commercial Insurance Lines

Line of insurance	Delivery expenses as a percent of premium ^a			
	Loss-adjusting expenses	Commission expenses	All other expenses	Total expenses
Group accident and health	4.9	8.1	9.3	22.3
1995 Buyup (adjusted 9-co. total)	3.6	16.2	7.4	27.1
1994 Buyup (adjusted 9-co. total)	3.2	16.0	8.2	27.5
Private passenger auto physical damage	8.4	8.6	13.9	31.0
Workers’ compensation	11.7	5.4	13.9	31.0
Other lines ^b	4.2	6.9	20.4	31.4

(continued)

Appendix VII
GAO-Adjusted Delivery Expenses for Buyup
Insurance in Relation to Published Data on
Commercial Lines of Insurance

Line of insurance	Delivery expenses as a percent of premium ^a			
	Loss-adjusting expenses	Commission expenses	All other expenses	Total expenses
Reinsurance	6.2	20.1	6.1	32.4
Other accident and health ^c	5.4	13.0	16.5	34.9
Personal lines ^d	11.2	10.0	14.2	35.4
Private passenger auto liability	13.0	8.5	14.1	35.6
Aircraft	8.1	14.4	14.1	36.6
Commercial auto physical damage	6.7	15.1	14.9	36.7
Total (average) all lines	12.6	11.2	14.8	38.6
Fidelity	7.3	13.0	19.3	39.6
Allied lines	7.4	15.1	17.6	40.1
Farmowners multiple peril	8.8	16.6	15.1	40.5
Commercial lines ^a	13.8	12.3	15.2	41.3
Commercial auto liability	13.0	13.3	15.2	41.5
Ocean marine	8.0	19.1	14.4	41.5
Homeowners multiple peril	11.2	16.1	14.9	42.1
Burglary and theft	5.2	14.6	22.7	42.5
Fire	5.2	17.3	20.0	42.5
Inland marine	5.7	17.5	19.5	42.7
Earthquake	14.3	13.8	16.2	44.3
Medical malpractice	30.7	3.9	11.3	45.9
Commercial multiple peril	15.9	17.4	18.3	51.6
Boiler and machinery	5.0	11.5	35.8	52.3
Other liability	27.7	11.0	14.5	53.2
Surety	9.6	19.1	28.9	57.6

(Table notes on next page)

Appendix VII
GAO-Adjusted Delivery Expenses for Buyup
Insurance in Relation to Published Data on
Commercial Lines of Insurance

Notes: Totals may not add because of rounding.

^aPercentage of premium data may be misleading because the amount of premium dollars involved per policy is not shown. In particular, premiums for some commercial insurance lines are significantly lower than for government crop insurance. Consequently, although expenses as a percent of premium may appear to be much higher for several commercial lines, the amount of expense dollars involved per policy is actually less than for government crop insurance. See comment 9 in app. VIII or comment 7 in app. IX for an explanation of how percentage of premium information should be interpreted.

^bOther lines includes glass, credit, mortgage guaranty, international, and miscellaneous.

^cOther accident and health includes credit accident & health.

^dPersonal lines include private passenger auto and homeowners multiple peril; commercial lines include all other lines, including earthquake.

Source: GAO's analysis of nine participating companies' data and data from Best's Aggregates & Averages: Property-Casualty, 1996 Edition (Oldwick, New Jersey: A.M. Best Company, Inc., 1996), pp. 174-178.

Comments From National Crop Insurance Services, Inc.

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



National Crop Insurance Services®

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March 25, 1997

Mr. Tom Cook
GAO
5799 Broadmoor, Suite 600
Mission, KS 66202

Dear Mr. Cook:

We are submitting to you per your request the accumulative industries' responses and comments pertaining to the GAO report entitled "Opportunities Exist to Reduce Government Cost for Private Sector Delivery." As you know several companies and trade associations have elected to send you their comments directly.

Tom, as I have indicated to you, we have elected to use outside consultants due to the highly technical nature and the inconsistent references used in the report. The reports from these consultants will be available to us in the next two weeks. Due to the short notice we have been given this is the quickest turn around we can accomplish. Therefore, we reserve the right to amend our comments at such time.

I will forward to you the consultants reports as soon as we receive them.

Sincerely,


Robert Parkerson
President

RESPONSE OF NATIONAL CROP INSURANCE SERVICES, INC.
TO THE DRAFT REPORT OF THE GENERAL
ACCOUNTING OFFICE ON CROP INSURANCE:
OPPORTUNITIES EXIST TO REDUCE GOVERNMENT COSTS
FOR PRIVATE-SECTOR DELIVERY

National Crop Insurance Services, Inc. ("NCIS"), an actuarial, statistical, and educational association of crop insurers, is responding to the March 5, 1997, draft Report to Congressional Committees of the United States General Accounting Office entitled "CROP INSURANCE: Opportunities Exist To Reduce Government Costs for Private-Sector Delivery" ("Draft Report"). NCIS is an association composed, among others, of all of the current holders of Standard Reinsurance Agreements ("SRA").

Upon receipt of the Draft Report on March 6, 1997, NCIS distributed copies to all of its members holding such SRA's. The text of this Response is offered on behalf of the NCIS membership.¹ NCIS' members are listed at the conclusion of the Response.

See comment 1.

¹Several members desired to offer individual comments in response, and their views are set forth in the Appendix. Readers of this Response, however, should not view the submission of individual company responses as indicative of any dissent from or disagreement with the positions set forth in this Response. To the contrary, the NCIS membership is united in its agreement with this Response.

INTRODUCTION

The GAO Report was prepared in response to a mandate from Congress to study and report on the cost-effective delivery of crop insurance to America's farmers. The report was to be a comprehensive review of the existing program to develop cost-saving measures within the USDA and the private sector partnership that would meet the budget goals of Congress and the risk protection needs of the farmer.

The GAO has taken 15-months, spent hundreds (perhaps thousands) of staff hours, collected data from nine private companies participating in the program and in the process spent hundreds of thousands of dollars of taxpayers' money. The result is that the GAO has failed to meet its mandate and has produced a report that demonstrates a clear lack of knowledge or understanding of the federal crop insurance program, reaches wrong conclusions, manipulates data and is often deliberately misleading. As a fundamental matter, the private sector crop insurance industry disagrees with substantially all of the GAO's findings, conclusions, methodologies and recommendations.

GAO Report Threatens the Success of the Program and Undermines the Crop Insurance Delivery System

The federal crop insurance program, which began on an experimental basis in 1938, struggled until 1980 to get participation even close to 20%. At that time, legislation was passed enlisting help from the private sector.

The partnership between government and private companies in the delivery of crop insurance to the American farmer is the most effective method of delivering a "safety net" to the agricultural community while asking the farmer to share in the costs and risks of his livelihood. The public sector brings the financial strength to support the "safety net" and the private sector brings the expertise in marketing, delivery and innovation along with sharing a portion of the

See comment 2.

risk with its government partners. Nowhere in the report does GAO discuss or even admit to the successes and efficiencies achieved by the public/private partnership.

The recent successes resulting from this partnership can be summarized as follows:

- Participation increased from less than 20% in 1980 to over 70% in 1996.
- Private industry developed CRC and Revenue Assurance risk management tools in conjunction with FCIC.
- Private industry involvement has lessened the delivery expense.
- Increased participation has eliminated dependence on ad hoc disaster assistance.
- The public/private partnership has improved loss ratio performance.

Throughout its discussion of the use of the administrative expense reimbursement by the private sector, the GAO report fails to recognize the nature and expertise of the government's business partners. The private sector brought to the program its expertise in marketing, risk sharing and service. A fundamental flaw of the report is the GAO's failure to recognize that crop insurance, similar to other forms of insurance, is sold, not bought. The marketing of crop insurance requires substantial motivation of the sales force and an intimate knowledge of the product and the customer.

One of the critical components of the private sector success in selling crop insurance is the agent. Without innovative marketing techniques and incentives designed to attract, motivate and retain qualified agents, success could not be achieved. Insurance companies maintain their agency force by providing incentives and service to the agents in the form of industry-competitive commissions

See comment 3.

and bonus incentives for additional premium. This in turn, assures the insured/farmer a quality program.

The private industry partnership has made the difference between a less than 20% participation rate, when the government sold the program, to the current participation rate of over 70%, when private industry applied its marketing expertise.

**GAO's METHODOLOGY DOES NOT JUSTIFY ITS CONCLUSIONS
REGARDING PROGRAM DELIVERY COSTS**

Industry believes that the GAO report does not address the true cost efficiencies of the current public-private partnership in relation to the recent fundamental improvements in overall program performance. Rather, the GAO report focuses on a narrow set of issues and not the "big picture" of successful program delivery. This is unfortunate because there are no useful points contained in the report which would serve as a basis for developing sound agricultural policy. Provided below are several examples of misrepresentation and obvious errors in the report. Space and time do not allow full enumeration of all the flaws in the GAO's report.

Business Cycle Reviewed Is Not Credible:

The GAO utilized statistical data collected from nine companies for two years, 1994 and 1995. These two years were the sole focus of the study, despite a wealth of data available for the business cycle, 1988-1995. It is not credible to assume that the GAO thought that a two-year sample was an acceptable business cycle in property/casualty insurance. Even the GAO admits that 1995 was a year of "relatively low crop losses" (Page 5 of the Draft Report). So why such a narrow focus?

The GAO excuses the scope of its sample by arguing that RMA did not require expense reporting by companies prior to 1994. However, a review of the SRA, beginning with July 1, 1989, clearly shows that RMA did in fact require expense reporting in the Plan of

See comment 4.

See comment 5.

See comment 2, app. IX.

See comment 6.

See comment 7.

Operation.² In addition, GAO spent a great deal of time collecting data from the nine companies, which certainly housed the expense data for a much broader sample than 1994 and 1995. NCIS was another source of data, as the statistical agent for all SRA holders, yet the GAO made no attempt to contact them. The GAO made no attempt to obtain any information beyond the narrow focus of two years.

See comment 8.

If the GAO had made a study of a credible business cycle, 1988-1995 for example, it would have found that the companies' actual expenses exceeded the amount reimbursed by FCIC in every year except 1995!

See comment 9.

Inaccurate Representation Of Industry Expense Data:

Now on pp. 31, 83 and 84.

Appendix VII.1 of the report incorrectly quotes from its original source and misrepresents the categorization and treatment of crop insurance expenses in relation to other lines of insurance. Loss Adjustment Expenses (LAE) are specifically included in the total expenses for the 1994-1995 nine-company adjusted buy-up totals (page 28, Figure 2.1 and page 86-87, Appendix Table IV.5). However, LAE is not included in the "All Other Expenses" category for the other property and casualty lines listed in Appendix Table VII.1 (page 100). (Best's Aggregates & Averages - Property-Casualty, "Cumulative By Line Underwriting Experience - Industry," pp. 174-178)

Now on pp. 92 and 93.

Note also that the property/casualty insurance industry ratios are based on a gross premium measure (comprised of claim costs plus expenses) whereas the crop insurance industry ratios are based on a premium measure that contains claim costs only. Expenses are not included in the crop premium. Therefore, the crop insurance percentages are **overstated relative to the rest of the industry**. On a comparable basis to the other industry percentages provided in

² Plan of Operation, Reinsurance Year Beginning July 1, 1989. This Plan required companies to report annual statement data as reported to state insurance departments and eleven financial ratios as contained in the National Association of Insurers Commissioners Insurance Regulatory Information System (IRIS).

Exhibit VII.1, the crop insurance industry percentages (re-stated) are as follows:

1995 Buy-up Commission expenses	11.6%
1995 Buy-up All other expenses (excl. LAE)	7.5%
1995 Buy-up Total expenses	19.1%
1994 Buy-up Commission expenses	13.0%
1994 Buy-up All other expenses (excl. LAE)	7.9%
1994 Buy-up Total expenses	20.9%

Restatement of the crop insurance numbers shows that the expense of delivering crop insurance is among the lowest for any line of property/casualty business. Thus, GAO misleads Congress with an "apples-to-oranges" comparison. An honest comparison would add back other lines' LAE.

GAO Fails To Find A Standard

The GAO cites five different sources of accounting authority to justify its disallowance of certain expenses within its report: GAAP, SAPP, FAR, NAIC and IRC. The GAO's need to seek so many authorities demonstrates the lack of consistent standards for expense allowability. The industry believes that its approach to expense management and allocation is reasonable.

There are other methodological errors and omissions in the report, many of a highly technical nature. In order to respond effectively to the GAO report, industry/NCIS has enlisted the aid of outside consultants, Putnam, Hayes & Bartlett, Inc. and Price Waterhouse LLC, specializing in the areas of economics and insurance consulting, to deal specifically with these aspects of the GAO report. NCIS believes strongly that consultants external to the process can help provide both government and private industry an unbiased perspective in coming to grips with the issues.

See comment 10.

MISREPRESENTATION OF CATASTROPHIC DELIVERY COSTS

The GAO's comparison of catastrophic insurance delivery costs between the government and private industry is misleading. In Chapter 3 of the Draft Report, the GAO states that the basic delivery costs of CAT in 1995 were "comparable" for the government and the private sector. The GAO then states that the private delivery of CAT was more costly because of the underwriting gain paid to the private sector. The inclusion of only one year's underwriting gain as a "delivery" cost completely distorts the cost of the catastrophic program.

See comment 11.

Finally, if the government's delivery of CAT was less expensive, the private sector's participation in CAT delivery is the reason for the government's savings. During the debate on the Reform Act, Congressman Pomeroy and Mr. Kenneth Ackerman, the FCIC's Manager, had the following dialogue:

See comment 12.

Congressman Pomeroy: Mr. Ackerman, I have some questions about costs and the implementation of the program. The nominal sign-up fee for the catastrophic level is set at a level essentially to cover processing costs. Have you done an internal analysis as to whether the USDA can ultimately deliver these policies for the costs or charge assessed to the farmer?

Mr. Ackerman: We are having a number of discussions with ASCS to talk through this very point, and those talks are still underway. We feel that with the \$50.00 or \$100.00 processing fee, we can work with ASCS or our partners in the Farm Service Agency to deliver this program. They will have to absorb, obviously, some cost, just as in the past they have had to absorb the cost of implementing ad hoc disaster bills. It will in fact put some strain on the organization in order to get this done, but we think it is a manageable one and we are starting to work through it with ASCS.

Congressman Pomeroy: I ask that you very carefully assess the relationship between actual cost to the agency and money received as an assessment from the farmer, because as you have acknowledged, the dollar amount was not fixed based on an analysis of cost.

In the event you are dramatically short, and I think you might be, there will be a fairly substantial dislocation of ASCS' resources and that raises a host of policy concerns that this committee would want to discuss.

Mr. Ackerman: If I may, one of the major variables in this calculation is to what extent the private sector will step in and aggressively market this product. We hope that they will and we hope that in most parts of the country, farmers give a choice and given a reasonable marketing effort by the private sector, that the bulk of this business will in fact go to the private sector.

Review of the Administrations' Federal Crop Insurance Reform Proposal, Hearings before the House Subcommittee on Environment, Credit and Rural Development, 103d Cong., 2d Sess., p. 30.

Failure of GAO to recognize or acknowledge previous government policy direction in implementation of the Reform Act is simply biased reporting and should not be condoned. At a minimum, industry is confused by Chapter 3 of the GAO report and believes that public policy makers will be misled.

GAO's PROPOSALS THREATEN AGENCY COMPENSATION STRUCTURE

At the beginning of Chapter 4, the GAO makes the statement that reimbursement based on a percentage "does not necessarily reflect the amount of work or cost involved" (page 51) with the sales and service of crop insurance. According to the GAO, the only real advantage of reimbursement as a percentage is its ease of administration. What the GAO fails to recognize is that reimbursement as a percentage of premium provides both the

See comment 13.

Now on p. 53.

See comment 14.

company and the agent with the proper incentive to market aggressively crop insurance products and that ultimately leads to higher program participation levels. Moreover, to set agent commissions as a percentage of premium is consistent with industry practice in other lines of insurance. To attract and sustain industry participation, industry must have a compensation arrangement consistent with other lines of insurance. Major changes to the reimbursement system would threaten agent participation and could destabilize the current delivery system.

See comment 15.

As proposed, recommendations in Chapter 4 of the GAO report will most likely result in further RMA micromanagement of the program, drastically alter the incentives to maximize participation, and greatly undermine agents' compensation. Provided below is an examination of the alternatives discussed in Chapter 4.

See comment 16.

Alternative 1: Cap on Reimbursement per Policy

The GAO focus is on absolute dollars paid on the largest policies proposes a cap. High premium dollar policies might be characterized by a large number of units, APH computations, or field inspections if a high value crop, each requiring a high level of service and additional costs. It is not clear from the report that GAO has carefully thought through the implication of capping reimbursements. Once a cap on reimbursement per policy is set, then agents will not have an incentive to market crop insurance because they will have other more lucrative alternatives in other lines of insurance.

See comment 17.

Alternative 2: Flat Amount per Policy Plus a Percentage

Under this alternative, the agent would again most likely maximize the number of policies, leaving less time to service each policy. This alternative would most likely entail additional micromanagement by RMA, resulting in even higher program costs. Given the complexity of the current program and the spatial distribution of policy holders, any alternative that would negatively impact on the long term viability of policy holder service should not be given any serious attention.

It is important to note that the RMA on March 20, 1997 sent the industry a draft SRA for the 1998 crop year which already proposes use of this alternative reimbursement proposal. It is bad enough that RMA has apparently adopted this alternative without even waiting for the industry response to the GAO's proposals, the comment period for which was through March 25, 1997. But they have once again rashly charged forward with adoption of a reimbursement alternative which even the GAO states "offers specific advantages and disadvantages" (Page 53 of the Draft Report), thereby clearly indicating the need for further study! It goes without saying that they are also charging ahead without giving any Congressional Committee an opportunity for reflection and input on such a radical change which clearly threatens the agents' compensation and incentive to service policyholders.

Alternative 3: Schedule of Allowable Expenses

This alternative implicitly (or not so implicitly) suggests that Federal Acquisition Regulations (FAR) provide an appropriate guideline for determining allowable expenses. Schedules of allowable expenses would only add an additional layer of administrative burden to an already top heavy bureaucracy. A schedule of allowable expenses would also reduce the flexibility and innovation of companies in their marketing strategies. The impacts of reduced policyholder service would be similar to the first alternative.

Alternative 4: Reduce Reimbursement as Volume Increases

At the margin, companies and agents would not be provided an economic incentive to maximize either program participation or service to the policy holder.

Summary of Conclusions Regarding Alternatives Proposed

Under the current system, the incentive for the agent is to maximize the value from every policy. The reimbursement or

Now on p. 56.

See comment 18.

See comment 19.

commission is the same on the first dollar as it is on the last. This is a very direct economic signal to the agent and the industry. Alternatives to the current reimbursement system should be analyzed carefully so that both the public and private sector understand the nature of the incentives implied by each alternative. Any change to the current reimbursement process should be given careful examination by all parties involved in the delivery system.

CONCLUSION

NCIS and its members undertake their responsibility to respond to the GAO Draft Report, and express the industry's regret that it was not offered the opportunity to formally participate with the GAO, USDA and RMA in the evaluation process.

It is unfortunate that the GAO takes such a narrow focus in discussing comparative costs between the public and private sectors. The current system of administrative expense reimbursement is very efficient in the sense that current program delivery costs are totally variable on an annual basis for the government. Reimbursement rates have declined in percentage terms virtually every year, resulting in savings to the government. Under the current arrangement for private sector delivery, government does not have to purchase and manage labor and capital assets. The private sector shoulders this responsibility with no promise of a long-term financial commitment with the federal government. The government faces no risk or responsibility with respect to capital asset management. This risk is borne entirely by the private sector. The GAO totally ignored this aspect of program cost delivery. This is unacceptable.

GAO's work is suspect because it completely fails to place its conclusions in context. Critical past milestones include:

- In 1989, Arthur Andersen & Co., working on behalf of FCIC, concluded: "... the FCIC reimbursement rate was generally not adequate to cover all direct and indirect expenses incurred by reinsured companies which could reasonably be associated with MPC I business."

See comment 20.

See comment 21.

See comment 22.

- In 1989, the Commission for the Improvement of the Federal Crop Insurance Program, created by Congress in 1988, found that reimbursement rates and commissions are "not adequate to ensure the widespread delivery of the federal crop insurance program."
- In 1995, in its report entitled "Crop Insurance: Additional Actions Could Further Improve Program's Financial Condition," GAO recognized explicitly that payments to the private sector are subsidies of the farmers' premiums, not cost reimbursement.

See comment 23.

Step-by-step, these past studies increasingly have emphasized the need for active, meaningful participation by the private sector in delivery of crop insurance and have shown the efficiency of the private sector, compared with other alternatives. The thrust of GAO's positions, however, argues for reversing (or even eliminating) the private sector's role. GAO embarks on this course without any attempt to reconcile its positions with the foregoing studies. In fact, once GAO's distortions, omissions, and improper methodology are examined, there is every reason to reject its positions.

See comment 24.

At a minimum, industry is shocked by the recommendations of the GAO report. Significant changes to the current process will derail the recent successes the program has begun to enjoy. If the GAO recommendations were to be implemented and resulted in a destabilization of the current delivery mechanism, then the political demand for disaster assistance could reappear. The re-emergence of such funding would have severe budget implications and be a nightmare for the future of agricultural policy.

Appendix VIII
Comments From National Crop Insurance
Services, Inc.

COMPANIES

- * Ag Hail Insurance Company
- * AgriServe, Inc.
- * American Agrisurance, Inc.
- * American Farm Bureau Insurance Services, Inc.
- * Blakely Crop Hail, Inc.
- * Butte Mutual Insurance Company
- * Carthage Mutual Insurance Co.
- * CNA Insurance Companies
- * Cotton Growers Hail Insurance, Inc.
- * Country Mutual Insurance Company
- * Crop Growers Insurance, Inc.
- * Farm Bureau Mutual Ins. Co. of Arkansas, Inc.
- * Farm Bureau Mutual Ins. Co. of Idaho
- * Farm Bureau Mutual Ins. Co. of Iowa
- * Farm Bureau Insurance Company of Nebraska
- * Graham Neville & Associates, Inc.
- * Grange Insurance Group
- * Great American Insurance Company
- * Grinnell Mutual Reinsurance Company
- * Hartford Insurance Group
- * IGF Insurance Company
- * Kansas Farm Bureau Mutual Insurance Co.
- * W. E. Kingsley Company
- * Millers Mutual Fire Insurance Company
- * National Farmers General Agency
- * National Livestock General Agency
- * Nationwide Crop Hail, Inc.
- * Nationwide Crop Hail
- * Nodak Mutual Insurance Company
- * North American Crop Underwriters, Inc.
- * North Carolina Farm Bureau Mutual Ins. Co.
- * North Central Crop Insurance, Inc.
- * Oklahoma Farm Bureau Mutual Insurance Co.
- * Producers Protective Association
- * Rain and Hail Insurance Service, Inc.
- * J. Rohwer & Co. - Arizona Crop Ins.
- * E. L. Ross, Inc.
- * Rural Community Insurance Services
- * Sooner Crop Hail Insurance Agency, Inc.
- * State Farm Fire and Casualty
- * United Farm Bureau Mutual Ins. Co. of Indiana
- * W. N. Van Camp Company
- * Walker Crop Insurance, Inc.

ASSOCIATE MEMBERS & REINSURANCE

- * Agricultural Loss Management Group
- * Agricultural Risk Management
- * Alexander Howden Canada Limited
- * American Agricultural Insurance Company
- * American Reinsurance Company
- * Bradstock Fox Craig Limited
- * Centre Reinsurance Company of NY
- * Centre Trading Partners L.P.
- * Chicago Board of Trade
- * Collins Associates, Inc.
- * Commercial Union Agricultural Service Ltd.
- * Copenhagen Reinsurance Company
- * E.W. Blanch Co.
- * F & G Re, Inc.
- * Folksam International Ins. Co. Ltd.
- * General Reinsurance Corporation
- * Greig Fester, Inc.
- * Guy Carpenter & Company, Inc.
- * Insurance Corporation of Hannover
- * Liberty Mutual Insurance Company (UK) Ltd.
- * Milliman & Robertson, Inc.
- * NAC Reinsurance
- * R+V Versicherung AG
- * Sedgwick Re
- * Sedgwick Reinsurance Intermediaries (Canada) Ltd.
- * Swiss Reinsurance Company
- * Totsch Enterprises, Inc.
- * Tyser & Co.
- * Unione Italiana di Riassicurazione SPA
- * Walbaum International
- * Wideland Insurance Brokers
- * Willcox Inc. Reinsurance Intermediaries
- * Winterthur Swiss Insurance Company

GAO's Comments

1. Because of publishing constraints, we did not reproduce the comments of individual members that the association provided in an appendix. However, copies of these comments are available from GAO's Director of Food and Agriculture Issues.
2. As we note early in the report, the insurance companies play an important role in delivering federal crop insurance. However, much of the program's success resulted from changes made by the 1994 reform act and the Federal Agriculture Improvement and Reform Act of 1996.
3. Over the last 15 years, the purchase of crop insurance has become more important to farmers. The 1994 reform act restricted disaster assistance payments, and the Federal Agriculture Improvement and Reform Act of 1996 made farmers more responsible for managing risk. As a result, farmers are more likely to purchase crop insurance. Therefore, while agents have to sell the product, farmers now have more incentives to purchase it. While we agree that incentives are important for attracting, motivating, and retaining a workforce, we question whether a taxpayer-supported program should be asked to reimburse certain expenses.
4. Our report was intended to respond to the mandate contained in the 1994 reform act. In planning our response, we developed an approach that addressed all of the questions in the law. For reporting purposes, we focused on the issue that the legislative history of the mandate indicated was of most concern to congressional decisionmakers—the cost of administering the program.
5. We used 1994 and 1995 data for our analysis because these 2 years provide a picture of expenses for delivering crop insurance before and after the implementation of the reform act. Because of industry concerns expressed early in our review about the use of this 2-year period, we considered the extent to which loss-adjusting expenses may change with varying loss experience as well as the extent to which loss-adjusting expenses may affect total administrative expenses. We found that high crop losses did not significantly increase companies' loss-adjusting expenses—the delivery cost factor most likely to be affected by high crop losses. For example, for buyup insurance, while companies paid out \$1.28 in loss claims for every dollar of premium received in 1995 and \$0.58 in loss claims for every dollar of premium received in 1994, their related loss-adjusting expenses as a percent of premium for these 2 years were not substantially different. Therefore, although losses were higher in 1995 than

in 1994, the companies' loss-adjusting expenses for processing these claims did not increase commensurately. In addition, loss-adjusting expenses are not a significant portion of total administrative expenses (about 3.5 percent of premiums on average for the nine companies we reviewed). Furthermore, since the 1980s, the crop insurance companies have received additional reimbursements in years of high crop losses.

6. The years we examined—1994 and 1995—were the first 2 years that the industry provided USDA with the detailed data needed to analyze the expenses associated with the selling and servicing of crop insurance. Data from earlier years were not available in a consistent, detailed format for analysis. In 1989, the companies were required to submit summary expense data and ratios, but according to FCIC, many companies did not submit these data and the data that were provided were not consistent between companies. Furthermore, in 1991, FCIC rescinded this requirement. In the 1995 standard reinsurance agreement, FCIC began to require companies to submit a detailed expense report in the National Association of Insurance Commissioners' (NAIC) format using NAIC guidelines for the prior calendar year—calendar year 1993. However, not all companies complied with the requirement until 1994.

7. We contacted National Crop Insurance Services, Inc. (NCIS) early in our review to discuss our review objectives and obtain the association's views. We spoke with NCIS officials during the course of our review and obtained data on company membership in NCIS. However, NCIS officials did not offer to provide any company expense data. Furthermore, because we had access to FCIC's and the nine companies' original data, we did not request company expense data from NCIS.

8. As discussed above, we believe that 1994 and 1995 were the 2 most appropriate years to analyze. Prior to 1994, companies did not report their expense data in a manner that is amenable to detailed analysis. As a result, we are not at all certain that the industry's assertion is accurate.

9. In appendix VII of our draft report, we inadvertently omitted the loss-adjusting expenses associated with commercial insurance lines in our presentation of commercial lines of insurance expenses in relation to the expenses of government-sponsored multiple-peril crop insurance. In response to the industry's observation on this omission, we revised the appendix to include reported loss-adjusting expenses. Contrary to the industry's assertion, however, we did not use this information to arrive at our conclusion of an appropriate reimbursement rate for delivering federal

crop insurance; we presented this information only because it was required by the 1994 reform act.

We did not use this information for our analysis because the percentages presented do not provide an appropriate comparison between commercial lines of insurance and government-sponsored multiple-peril crop insurance for several reasons. First, the expense ratios for commercial lines are based on premiums that include both risk and expense factors, while the expense ratios for multiple-peril crop insurance are based on premiums that include only a risk factor. Second, we did not verify the ratios for the commercial lines of insurance, and hence we cannot speak to the accuracy of the cost elements that have been included in the computations of those ratios. Finally, premium rates for commercial insurance lines are significantly lower than average rates for multiple-peril crop insurance. As a result, if a comparison to other lines of insurance is to be made, the only appropriate comparison is on a dollars-per-policy basis, not on a percentage-of-premium basis. Although expenses as a percent of premium may appear to be much higher for several commercial lines, the amount of expense dollars involved per policy is actually less than for government crop insurance.

If we examine the dollars paid per policy instead of the percentage of premium per policy, the reimbursement for multiple-peril crop insurance per dollar of premium substantially exceeds the reimbursement for other lines. For example, in 1995, according to NAIC, the average consumer payment for private passenger automobile insurance was \$666 per vehicle, and the reported delivery expense rate was as much as 35.6 percent, or \$237. In comparison, for 1995 buyup crop insurance, the average premium was \$1,905 per policy, and the 31-percent reimbursement rate resulted in an average payment to crop insurance companies of \$591—or about 2.5 times more than the dollar value of delivery expenses for private passenger automobile insurance. If the reimbursement rate had been 27.1 percent in 1995, as we believe would have been appropriate for that year, the crop insurance companies would have received an average reimbursement payment per policy—\$516—an amount that is still more than double the dollar value of delivery expenses for this private passenger automobile insurance. A comparison of the reimbursement for multiple-peril crop insurance on a dollars-per-policy basis to other insurance lines yields similar results.

10. We welcome any additional perspectives. However, while NCIS asserts that the industry's consultants will bring an "unbiased perspective" to the

issue, we question how consultants hired by the industry can be truly objective. In any event, we cannot assess the contribution of these consultants to the issue without seeing their product.

11. At the time of our review, the industry and the government had only 1 year of experience with the catastrophic insurance program. Furthermore, in 1996, the underwriting gains on catastrophic insurance were higher than in 1995.

12. As we state in chapter 3, the government's costs for delivering catastrophic insurance are higher through private insurance companies because these companies earn underwriting gains, and USDA does not.

13. We recognize that government policy is to move the sale of catastrophic insurance to the private sector. Our report simply analyzes the differences in costs for the two delivery systems. As we state in chapter 3, our only recommendation is that FCIC closely monitor the underwriting gains associated with private-sector delivery of this insurance in the context of FCIC's long-term target.

14. While the industry's comment focuses on agents' compensation, our report focuses on the government's reimbursement arrangements with companies, not agents. We recognize that companies can compensate their agents in ways that they consider appropriate, regardless of the companies' arrangement with the federal government.

15. As required by the 1994 act, we examined the advantages and disadvantages of alternative reimbursements to private companies—not agents—and did not recommend one alternative over another. Furthermore, we noted that the insurance companies prefer the current system.

16. As we recognize in chapter 4, this capping alternative has the disadvantage of possibly discouraging some companies from aggressively marketing larger crop insurance policies for FCIC. However, our review showed that a capping alternative that achieved an overall 24-percent reimbursement rate for administrative expenses would affect only the largest 5 percent of policies.

17. We agree that this alternative may require additional oversight by FCIC, as we state in chapter 4. While the industry appears to believe that this alternative provides no incentive for delivering crop insurance, we believe

that one component of the alternative—the percentage of premiums—would continue to serve as an incentive.

18. While we agree that this alternative is likely to increase FCIC's administrative workload, we discuss it simply to present a widely considered alternative for delivery of government services. Moreover, at least one company within the industry believes that the Federal Acquisition Regulation (FAR) is an appropriate alternative. In 1993, one company testified before the Subcommittee on Agriculture, Rural Development, FDA, and Related Agencies, House Committee on Appropriations, that it endorsed the FAR as an appropriate reimbursement arrangement.

19. As we note in chapter 4, this alternative may discourage some larger companies from aggressively delivering crop insurance.

20. In any competitive business, companies must shoulder certain expenses for the opportunity to earn profits. However, in the case of the federal crop insurance program, companies are paid for these expenses through the administrative expense reimbursement. In addition, the companies have the opportunity to earn profits through underwriting gains.

21. We examined the two 1989 reports as part of our review, and to the extent that they provided information applicable to the current crop insurance program, we considered it. However, in so doing, we noted that the program's size and nature has changed significantly since the 1980s.

22. We do not challenge the industry's characterization of the administrative expense reimbursement as a form of subsidy, but it is not clear what the significance of this alternative terminology is. Regardless of the terms used to describe this payment to insurance companies, it is clear that the reimbursement to companies is intended to compensate them for the reasonable expenses associated with selling and servicing crop insurance, not to provide them with an additional source of profits. To believe otherwise, would negate the rationale for the mandated joint GAO/FCIC study of the adequacy of the administrative expense reimbursement.

23. As we note in the introduction to our report, the crop insurance companies play an important role in the delivery of federal crop insurance. Nothing in our report suggests that their role should be reduced or

eliminated. However, continuing emphasis on reducing the federal budget requires FCIC to ensure that it is not paying more than is necessary to implement the crop insurance program.

24. We do not believe that lowering the reimbursement rate will destabilize the crop insurance industry. A lower reimbursement rate—in the range of 24 percent—will adequately compensate companies for their reasonable administrative expenses to deliver crop insurance and should not diminish service to farmers and still allow profits from underwriting.

Comments From the American Association of Crop Insurers and the Crop Insurance Research Bureau, Inc.

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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Joint Comments Prepared by AACI and CIRB On Draft GAO Report

“Opportunities Exist to Reduce Government Costs for Private-Sector Delivery”

The American Association of Crop Insurers (AACI) and Crop Insurance Research Bureau (CIRB) appreciate the opportunity to provide comments on the GAO draft report dated March 5, 1997. We highly value the important role of the private sector in the Federal crop insurance program. Our associations are dedicated to working cooperatively with Congress and the Executive Branch to insure that the risk management needs of America’s agricultural producers continue to be met in a meaningful and cost-efficient manner.¹

GAO Report Is Biased and Fails To Comply With The Law

The crop insurance industry strenuously objects to the conclusions made by the General Accounting Office. The report is *flawed* in many respects, the most serious of which is that it does not comply with the law. It is not fully responsive to the general Congressional mandate of Section 118 of the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 (P.L. 103-354, hereinafter Reform Act).

Section 118 requires GAO and the Federal Crop Insurance Corporation (FCIC) to jointly evaluate the financial arrangement between FCIC and approved insurance providers “to determine the quality, cost and efficiencies of providing the benefits of multiple peril crop insurance to producers of agricultural commodities . . .” However, the entire GAO report concentrates on one narrow topic — cost. The report is extremely biased, with one objective in one mind, recommending a substantial reduction in the rate of reimbursement to private insurance providers.

GAO Use of Two Years of Data is Biased

This bias is illustrated by GAO’s arbitrary use of statistically insupportable and indefensible data from only two crop years. One year had the best loss ratio in the program’s history and the other, absent prevented planting claims, was also a “year of relatively low crop losses” according to the GAO itself. It is obvious that the GAO’s choice of *this* data was for the sole purpose of supporting a reduction in premium subsidies for A&O.

¹ For a better understanding of the unique nature of the crop insurance business to help you better evaluate the GAO report and these comments, we encourage you to read Appendix I attached to these comments.

See comment 1.

See comment 2.

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GAO Recommendation Based on Speculation

The report's recommendation to reduce premium subsidies for administrating and operating expenses (hereinafter A&O) by 17% from the scheduled 1998 level heavily relies on the probability of higher crop prices in future years, based on increased prices in 1995 and 1996 — prices which have already dropped in 1997. Anyone with even a rudimentary knowledge of U.S. agriculture clearly knows that two things are certain:

- (1) **There will not be good weather every year** — Some years will experience severe and disastrous crop losses. That is why we have a crop insurance program.
- (2) **There will not be high crop prices every year** — The rural landscape is still littered with the remains of the farms and financial institutions that engaged in the speculative expansion frenzy in the 1970s which was brought down by the ensuing lower prices.

GAO Used The Wrong Auditing Methodology

The GAO used a fundamentally flawed methodology in conducting its audit. It audited the books of private insurance companies as if they were a federal contractor under the Federal Acquisition Regulations (FAR). The GAO report treated the companies as if they were receiving a cost-plus federal contract rather than a performance- and incentive-based reinsurance agreement where companies have every possible incentive to lower expenses to increase their bottom line. It is indefensible to apply FAR auditing standards to this entirely different kind of financial relation.

GAO has failed to understand the very nature of the competitive insurance business. Given the catastrophic nature of the program and fundamental business economics, a company must plan to try and keep expenses that are within its control below income. In the case delivery of Federally subsidized MPCl, the income is the premium subsidy for administrating and operating expenses (hereinafter A&O). If the premium subsidy rate is 35% of premium, then expenses must be kept below that to the maximum extent possible. The same is true whether the rate is 31%, 27%, or 11% except that there is a point of no return where the functions required can no longer be performed for the income provided. Service to the farmer suffers, participation cannot be maintained, quality control is unaffordable, and the program collapses. As the GAO report actually supports and these comments reinforce, the levels of A&O premium subsidy provided by current law are not excessive, rather they strike a delicate balance between service and cost.

The only objective criteria upon which the delivery of the private sector can be based are the quality of service and the rate of compensation compared with other lines of insurance. An analysis of these criteria will indicate whether crop insurance services are sufficiently available to the ultimate customer and whether the taxpayer is getting a good deal for the money invested in providing such services. These comments convincingly illustrate that the private companies delivering MPCl for the government provide superior quality services to the American farmer despite the fact that the rate of compensation is below all other lines of insurance. Unfortunately, the GAO report fails to address quality of service at all, and it fails to objectively compare costs between lines of service as noted below.

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GAO Has Misstated Insurance Industry Data

Further illustration of GAO's bias is its selective use of widely accepted insurance cost data in order to justify its initial conclusion that the companies are being overpaid and should be paid less. In response to the statutory mandate that the GAO compare delivery costs of multiple peril crop insurance to other insurance coverages that the provider may sell, GAO selectively used data from A. M. Best tables that purported to show that the cost of crop insurance delivery was higher than the delivery of other lines of insurance. By leaving out an important component of those tables (loss adjustment expense) and failing to convert the crop insurance A&O premium subsidy to an expense-loaded equivalent, GAO supported their conclusion that the insurance companies are overpaid for MPCCI delivery. **However, had complete data been used, it would have demonstrated that MPCCI delivery costs less than all other lines of insurance.** In fact, the rate paid in 1994-96 to reinsured companies by the Federal Crop Insurance Corporation for delivery of multiple peril crop insurance (MPCCI) was nearly 42% LESS than the average cost of delivery of private farmowner multiple peril (property/casualty) policies.

Publication of the Report Should be Delayed

For the foregoing reasons, and others demonstrated in our comments, the GAO report amounts to a biased conclusion in search of supporting data, rather than the fair and balanced evaluation of the quality, cost and efficiencies of the program that was mandated by the statute. The public interest is not served by a biased and incomplete report that misstates the character of the crop insurance program and recommends a substantial change in policy based on erroneous data, assumptions, and methodology. **Therefore, we request that the final report not be issued until additional work has been done to correct the draft's glaring omissions and to fully comply with the statute. We certainly also strongly advise against the Secretary of Agriculture taking any action based on the draft report until the identified errors and omissions are corrected.**

WHO WE ARE

These comments are offered on behalf of AACI and CIRB, two of the three national trade associations representing private insurers involved in the Federal crop insurance program.² AACI and CIRB collectively represent all but one of the private companies currently holding a Standard Reinsurance Agreement with the Federal Crop Insurance Corporation (FCIC). These companies, from the smallest to the largest in the industry, provide billions of dollars in crop hail and multiple peril crop insurance (MPCCI) protection to American agricultural producers in every state in the union. The central mission of these associations is to continuously improve crop insurance -- both

² We also note that our sister trade association, NCIS, has filed its own comments with which we concur. In addition, NCIS has commissioned two private studies, one by Price Waterhouse L.L.C. and the other by Putnam, Hayes, & Bartlett, Inc., to address the same issues as this GAO report and will be issuing those reports independently of these comments and this report. We commend these reports to the GAO, the Secretary of Agriculture, the House and Senate Agriculture and Appropriations Committees, the Risk Management Agency, and everyone who may read the GAO Report.

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the private and Federal programs -- and support efforts to strengthen and increase the efficiency of the crop insurance program aimed at serving the risk management needs of the American farmer.

EXECUTIVE SUMMARY

I. GAO HAS NOT COMPLIED WITH THE LAW. The Comptroller General (hereinafter GAO) and the Federal Crop Insurance Corporation (hereinafter FCIC) have failed to meet the statutory purpose and mandate that served as the sole basis of this report. This is especially grievous given the historical criticism of performance this program has received in previous GAO reports. We strongly believe this study provided an opportunity for and required GAO to comprehensively review the program's recent performance against historical performance that has been the subject of criticism. If done properly, the report would probably be entitled, "Private-Sector Delivery Has Increased Farmer Participation and Reduced Costs to the Government."

Curiously, the draft GAO report fails to include a copy of the statutory mandate that serves as the basis for the entire exercise. Section 118 of the Reform Act (7 U.S.C. 1506 note) contains five subsections outlining the general and detailed scope of the "Crop Insurance Provider Evaluation" as that section is entitled. The text of the entire provision is provided below with the underlined areas representing those requirements where the current draft report is deficient:

* * * * *

(a) In General.--The Comptroller General of the United States and the Federal Crop Insurance Corporation (referred to in this section as the "Corporation") shall jointly evaluate the financial arrangement between the Corporation and approved insurance providers to determine the quality, costs, and efficiencies of providing the benefits of multiple peril crop insurance to producers of agricultural commodities covered under the Federal Crop Insurance Act (7 U.S.C. 1501 et seq.).

(b) Collection of Information and Proposals.--The Corporation shall require private insurance providers and agents to supply, and the private insurance providers and agents shall supply, records and information necessary to make the determinations and evaluations required under this section. The Corporation shall solicit from the approved insurance providers and agents proposals for modifying or altering the requirements, regulations, procedures, and processes related to implementing the Federal Crop Insurance Act to reduce the operating and administrative costs of the providers and agents.

(c) Initial Report.--Not later than 180 days after receipt of information and cost-reduction proposals under subsection (b), the Corporation shall evaluate the information and proposals obtained and report the results of the evaluation to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate.

(d) Final Report.--Not later than 2 years after the date of enactment of this Act, the Comptroller General and the Corporation shall submit a final report that provides the evaluation required under subsection (a) to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate. In making the evaluation, the Comptroller General and the Corporation shall--

(1) consider the changes made by the Corporation in response to increased program participation resulting from the enactment of this Act;

See comment 1.

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(2) include an evaluation and opinion of the accuracy and reasonableness of--

(A) the average actual costs for approved insurance providers to deliver multiple peril crop insurance;

(B) the cost per policy of complying with the requirements, regulations, procedures, and processes of the Federal Crop Insurance Act;

(C) the cost differences for various provider firm sizes and any business delivered by the Federal Government;

(D) the adequacy of the standard reimbursement for potential new providers; and

(E) the identification of any new costs related to the enactment of this Act not previously identified in the information reported by the providers;

(3) compare delivery costs of multiple peril crop insurance to other insurance coverages that the provider may sell and determine the extent, if any, to which any funds provided to carry out the Federal Crop Insurance Act are being used to fund any other business enterprise operated by the provider;

(4) (A) assess alternative methods for reimbursing providers for reasonable and necessary expenses associated with delivery of multiple peril crop insurance;

(B) recommend changes under this paragraph that reasonably demonstrate the need to achieve the greatest operating efficiencies on the part of the provider and the Corporation has been recognized; and

(C) identify areas for improved operating efficiencies, if any, in the requirements made by the Corporation for compliance and program integrity;

(5) assess the potential for alternative forms of reinsurance arrangements for providers of different firm sizes, taking into consideration--

(A) the need to achieve a reasonable return on the capital of the provider compared to other lines of insurance;

(B) the relative risk borne by the provider for the different lines of insurance;

(C) the availability and price of commercial reinsurance; and

(D) any additional costs that may be incurred by the Federal Government in carrying out the Federal Crop Insurance Act; and

(6) include an analysis of the effect of the current or proposed reinsurance arrangements on providers having different business levels.

(e) Information.--

(1) Privacy.--In conducting the evaluation required by this section, the Comptroller General and the Corporation shall maintain the privacy of proprietary information.

(2) Subpoenas.--The Comptroller General shall have the power to subpoena information relevant to the evaluation required by this section from any private insurance provider. The Comptroller General shall allow the Corporation access to the information subpoenaed taking into consideration the necessity of preserving the privacy of proprietary information. (Emphasis added; Underlined portions represent those that the report has failed to address.)

The failure to include the evaluation of the reinsurance arrangement, the failure to consider "quality . . . and efficiencies of providing the benefits of [MPCI] to producers", and the failure to

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address a number of the specific requirements for this report leave little choice but to recommend that the publication of this report be delayed until the statute is complied with. If this is not done and the report is published, we would certainly expect that GAO and FCIC will complete the job that was assigned to them and that no recommendations would be made or acted upon until that task was complete. Unfortunately, the Administration has already based its budgetary recommendations on the flawed analysis in this draft report, so that significant damage to the program has already been done.

II. **GAO's CONCLUSIONS BASED ON WILDLY SPECULATIVE ASSUMPTIONS.** The only basis given for the GAO's conclusion and recommendation that the FCIC could reduce the current A&O premium subsidy to 24 percent or less is the expenses realized in two of the best years in history of the crop insurance program, speculation about increased crop prices and premium rates, and unfounded hopes for administrative savings to be achieved by FCIC actions. The policy or mechanism utilized for providing the most efficient and cost-effective delivery of the benefits of MPCIC to American producers of agricultural commodities cannot be reasonably based on these criteria. At the least, 1994 and 1995 expenses need to be recalculated as if there were a historically normal crop loss year whether that be the 15-year average 1.23 loss ratio or the statutorily imposed loss ratio target of 1.075. An analysis taken over an entire business cycle would be the most statistically sound. The GAO assertion that it used only 1994 and 1995 data because 1994 was the first year such data was reported is false. FCIC has required companies to report such data since the 1989 SRA.

Certainly no reasonable public policy maker would base a decision so central to the stability of the now most important safety net program for American farmers on speculation about crop prices and good weather. To base major program changes on the cost of delivering the crop insurance program on two of the better loss experience years (adjusting 1995 for the prevented planting additional benefits) in the history of the program is pure folly, given its 15-year 1.23 average loss ratio. To have major change in the crop insurance program based on the assumption that crop prices will continue to be high is also pure folly.

III. **GAO HAS USED FAULTY METHODOLOGY THROUGHOUT ITS REPORT.** The federal contracting audit methodology applied by GAO in this report is totally unsuited to the nature of the crop insurance public-private partnership. The methodology employed is based on the Federal Acquisition Regulation (FAR) system — which numerous Congressional hearings and media reports have exposed as a very wasteful, inefficient, and discredited system of procuring goods and services for the government. As a colossal failure (symbolized by the \$600 toilet seat), it is finally undergoing some significant reforms. Instead of discrediting the performance-driven, cost-reducing, non-expense-inflating, and incentive-based system utilized in the crop insurance program through the application of this inappropriate methodology, GAO should hold out the crop insurance system as a model for other government agencies.

IV. **GAO's CONCLUSIONS DEFY CLEAR INTERPRETATION OF DATA.** GAO references widely accepted data on the expenses of other lines of insurance as a comparison for the A&O premium subsidy provided to crop insurance companies. If that data is adjusted to utilize the same measuring units (expense loaded or non-expense loaded) and to incorporate all costs that are included in the A&O premium subsidy, it is an irrefutable fact that the government is getting high

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performance delivery of crop insurance at a substantial bargain price. Given this fact, then GAO's recommendation to further reduce the A&O premium subsidy is in direct conflict with the requirement in Section 507(c)(2) of the Federal Crop Insurance Act (hereinafter Act)(7 U.S.C. 1507(c)(2)) that FCIC "contract with private insurance companies . . . and reimburse such companies for the administrative and program expenses, as determined by the Board, incurred by them, under terms and provisions and **rates of compensation consistent with those generally prevailing in the insurance industry.**" (Emphasis added.) While provisions adopted in the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 (P.L. 103-354, hereinafter Reform Act) did cap these rates of compensation, this requirement still applies within those caps.

Additional Recommendations

These comments are offered as a means to help GAO correct what is an incomplete draft of a comprehensive study required by Congress. We hope GAO takes this opportunity. We hope and trust the GAO will publish these comments with their accompanying attachments in their entirety as an appendix to, but within, its final report. If GAO adopts some of our recommendations, the relevancy of the comments will change. If GAO is unable to print the entire requested portions, we would certainly like to be consulted as to which portions are included in the report.

In addition to the central recommendation to delay publication of the draft GAO report until the Congressional mandated comprehensive study is complete, additional fundamental recommendations with respect to the draft report are for GAO:

- ▶ to strongly reconsider the narrow nature of its analysis and what is an apparent preconceived outcome of the study;
- ▶ to further review the fundamentals of insurance and reevaluate its analysis and recommendations based on that review;
- ▶ to consider the quality, efficiency, and timing of the service provided by the private sector in comparing private to government delivery costs;
- ▶ to expand the analysis to cover a more normal loss year (expenses have been reported to FCIC since the 1989 SRA);
- ▶ to either expand the study to be a full review of the risk bearing portion of the Standard Reinsurance Agreement or eliminate all references to that aspect of the business;
- ▶ to conduct a much more thorough analysis of the volatility of crop prices and premiums historically and prospectively before recommending such a drastic reduction in the premium subsidy for administrative and operating expenses; and
- ▶ to estimate the impact of its proposed recommendation on:
 1. Service to farmers -- i.e., will that level of reimbursement support the type of infrastructure necessary to adjust and pay claims as timely as they are now; will companies offer as many products; will there be as many agents/companies to choose from?
 2. Rural jobs -- i.e., will agents drop out and how many?
 3. Jobs and competition -- i.e., will some smaller companies be forced out of the program?
 4. Risk management education -- i.e., will agents and companies be able to afford to sponsor as many farmer meetings as they have in the past?

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5. Program integrity -- i.e., will quality control suffer?

We are, of course, still awaiting the report to Congress from the Risk Management Agency regarding regulatory cost reduction that was due, by law, well over a year ago. While commenting very briefly on the simplification items within this report, we will reserve extensive comments for the industry comment section of that upcoming report.

Ken Ackerman, Acting Administrator of the Risk Management Agency and FCIC Manager has noted that recent public policy changes have redefined the Government's role in providing assistance to farmers, and "the key result has been to elevate Federal crop insurance into the principal pillar of the remaining 'safety net' for the American farmer". **We fear conclusions and recommendations contained in the draft report that have already been used as the basis for the FY98 budget proposal and forwarded in testimony before key House and Senate Subcommittees stand to strongly weaken that pillar.**

GAO REPORT FALLS FAR SHORT OF STATUTORY MANDATE

The law, as provided in full above, is very clear. The insurance provider evaluation was to be a comprehensive and joint exercise. We should be commenting on a joint and complete product. The report notes that the portion of the evaluation to be performed by FCIC is not yet complete and to the extent either portion was performed jointly is not evident from the report except that discussions were held and judgements rendered by FCIC. However, there is no explanation of the rationale for FCIC's judgements contained in this report. Furthermore, even if GAO and FCIC do not intend to abide by the comprehensive report requirements contained in the law, it would still be prudent to withhold publication of the final report until FCIC has completed that portion of the report which it is working on and industry has had an opportunity to comment upon it.

The law is also clear that this undertaking was to be a comprehensive analysis of the "quality, costs, and efficiencies of providing the benefits" of MPCIC to farmers. This GAO report focuses virtually solely on the costs of delivery and contains no evaluation or opinion on the quality and efficiencies of providing those services. While we believe we also satisfy any reasonable cost-effectiveness and non-wasteful cost standards, we stand very firmly on the fact that the quality and efficiencies of the private sector's delivery of crop insurance stand head and shoulders above other means of delivery. We can improve and will improve because we are customer driven, but the industry has matured into a smooth functioning, innovative, capable, and professional system exemplified by its ability to handle the doubling of the program since 1994. The GAO report should make some attempt to evaluate these aspects as well.

The more detailed requirements of the final report called for under the law (Sec. 118(d)) have also not been met by the draft GAO report. It does not consider the changes made by the Corporation in response to the Reform Act. **The completely inept handling of the multiple entity issue that led to the drive to eliminate the mandatory purchase requirement of the program would be a good issue to evaluate in this regard.** GAO has made no attempt to measure the average cost per policy of complying with FCIC's mandates. There is no evaluation of any cost differences among firms of different sizes or of the adequacy of the A&O premium subsidy for

See comment 1.

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potential new providers. There was no identification of the additional costs imposed by the Reform Act.

Data was included with respect to other lines of insurance to help address Sec. 118(d)(3), but as noted above that data was not converted to equivalent measures used in MPCIC and the full range of data was either not considered. We trust this was simply an error and will be corrected in the final report. **Properly corrected, the report will note that the premium subsidy for A&O provided to crop insurance companies by FCIC is a bargain compared to other lines of insurance.**

The inclusion in the report of the statement, "the companies have no obligation to spend their payment on crop insurance-related expenses; they can spend the payment in any way they choose" contains a very strong connotation that companies are not, in fact, spending the money on crop insurance related activities and this is very disturbing. Congress directed GAO and FCIC "to determine the extent, if any, to which any funds provided to carry out the Federal Crop Insurance Act are being used to fund any other business enterprise operated by the provider." If GAO found evidence that such cross-subsidization was occurring then it should straightforwardly so state. However, if it did not find any, then the report should contain an equally straightforward statement.

There is no recommendation whatsoever regarding any need for improvement of operating efficiencies, an area that Congress considered critical since it had already mandated a reduction in A&O premium subsidy under the Reform Act. Finally, as noted above, the failure of FCIC to provide the evaluation of the reinsurance arrangement is a failure of the comprehensive evaluation and the report should be withheld until that analysis is completed. All references to underwriting gain should be excluded from the GAO report if it is not to include this portion of the analysis. If discussion of underwriting gain remains in the GAO report, then a more complete explanation of the process including the social aspects of the program and the fact that distribution of reported gains are restricted indefinitely must be included. (See Item I. of Appendix I.)

**CONCLUSION THAT REIMBURSEMENTS COULD BE REDUCED
IS BASED ON FAULTY METHODOLOGY, MISUNDERSTANDING
OF CROP INSURANCE BUSINESS, SPECULATION**

Principal Finding No. 1

GAO's first principal finding that reimbursements exceed delivery expenses is based on faulty methodology, failure to consider a statistically significant amount of data from more than two crop years, inappropriate exclusion of expenses reasonably related to delivery, and a general lack of understanding of the nature of selling and servicing crop insurance. In addition, it is unconscionable that GAO makes no consideration of the value of the performance that was rendered for the reimbursements provided that have helped the government achieve, for the first time in the history of the crop insurance program, the program's primary objective.

Faulty Methodology. As the GAO finds, the expenses incurred in 1994, as reported on Exhibit 20 to the SRA, were above the amount of funds received by industry for that year. Only after GAO excludes certain expenses do the A&O premium subsidies exceed expenses incurred.

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With respect to 1995, there is little argument that expenses, before GAO adjustment, were lower than the A&O premium subsidies paid to the companies. **However, as stated below, if companies do not attempt to keep expenses below the amount they are to receive in reimbursements, then they are purposely planning to put themselves out of business.** Any prudent businessman must attempt to keep costs below the reimbursement rate if he is to remain in business.

There is no hint anywhere in the draft report that GAO recognizes this concept. This is a fundamental and undermining flaw in the analysis and recommendations as contained in the draft report. Thus while the findings may have some validity, we disagree that the conclusion that companies were paid more than their expenses means there has been a waste of taxpayer resources or that "opportunities exist to reduce government costs for private-sector delivery." To the contrary, we believe "Private-Sector Delivery Has Increased Farmer Participation and Reduced Costs to the Government."

The methodology employed in the audit and reflected in the final report is that GAO treated the private insurance companies as standard government contractors or government agencies. Under most government contracts, companies submit invoices or expense reports to be reimbursed for performing certain tasks, i.e. building an airplane. The company has little incentive to keep costs down, since under a cost plus contract it will receive, within certain parameters, its costs plus a margin for return on capital.

Similarly, government agencies have a "use-it-or-lose-it" mentality when it comes to spending budgeted amounts. If an agency does not spend the money allotted to it in a given year, it generally doesn't get to keep any leftovers for next year and may have its future year's budget reduced due to its failure to expend the funds allotted the prior year.

Under the crop insurance program, companies are not given the luxury of being paid for their costs plus a margin. If they were, GAO's audit would have found much higher expenses than it did. Instead, the companies are told they will receive a certain portion of premium as the reimbursement for expenses it will incur. This is done in July of the year preceding the upcoming crop year when the company has no knowledge of crop price elections or what acreages may be planted and insured in the coming year, especially now under the new farm program.

Therefore, the only prudent business decision is to aim to keep expenses below the rate one is to be paid, otherwise the company would have to utilize capital surplus, income from other lines of insurance, or borrow money simply to meet its payroll for expenses over which it often has little control. Companies also have no idea what type of loss year they will have. **Given these facts about business economics, GAO's finding that its adjusted company expenses were below reimbursement levels in 1994 and 1995 are far from surprising.** In years of very low losses, expenses will not and should not reach the level at which you are compensated. If they did, they would run the risk of putting the whole company in financial jeopardy had the year turned out otherwise (high losses and high loss adjustment expenses). When losses are high, not only are A&O costs increased, but underwriting losses, not gains, are more probable leaving few places from which to secure the funds to cover the A&O costs.

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See comment 5.

Companies do adjust operations to fit their costs within the expense parameters provided, leaving room for above average losses and desiring some return on investment of capital in physical and human resources. However, there are points of no return where there is no room to handle the above average losses or to provide any return on capital or to pay commissions necessary to motivate the agents to bother with crop insurance, the most complex and paperwork intensive line of business in which most agents are involved. Beyond a certain point service to the farmer suffers, participation cannot be maintained, quality control is unaffordable, and the program deteriorates and eventually collapses. We cannot afford this result in the new agricultural risk environment facing American farmers today. **GAO's recommendation, as well as that contained in the Administration's FY98 Budget go far below that point of no return. A 20% straight cut in the rate below the 1996 A&O premium subsidy is beyond nearly every company's ability to adjust.**

See comment 6.

See comment 11.

The Nature of the Business is Different. Crop insurance has historically not been something that farmers come knocking on agents' doors to sign up for. **It is not bought, it must be sold to the farmer.** To accomplish this task, the proper incentives and services must be provided to insurance agents who have a choice of lines to write and companies for which to write. Furthermore, the very nature of the product requires an incredible amount of education, record keeping, and professional counseling to match protection with risk. As a paperwork intensive and continuously changing line of insurance, agent commissions for crop insurance that may be above industry averages are wholly justified and completely understandable by those familiar with the product and the program.

See comment 12.

One must also recognize the reverse cash flow element of the crop insurance business. Both companies and agents essentially work for free from December until August when acreage reports are filed, actual premiums are calculated, and A&O premium subsidies are paid. In the meantime, there are no flows of funds from FCIC to the companies or companies to agents for the administrative costs incurred during this time. If companies did not plan to have some funds left over year to year then there would be no money to meet payrolls, train agents and adjusters, cover early season loss adjustment and growing season inspections, rent office space, purchase equipment necessary for the servicing of the business, or pay to reprogram the computers to meet the latest changes in FCIC procedures and data requirements.

See comment 13.

Expenses Lag Increased Activity. Another flaw in GAO's analysis of expenses is the failure to recognize the lag time in meeting the demands of growth. As exemplified by the Risk Management Agency's own justification for an increase in its FY98 budget, during periods of rapid growth, resources are stretched to the maximum. This was certainly true in 1995 when the private sector added over 500,000 policies to its book of business. This was an amazing accomplishment in a very short period of time that did not allow for the hiring of additional staff and the employment of additional technical resources necessary to sustain such levels of activity over time or probably to handle any significant amount of loss claims in a timely fashion had they occurred that year. Those hirings and that additional capital investment often come in the year(s) following rapid growth. Such is the case in the crop insurance industry.

If staff levels in companies in 1996 and 1997 are compared with 1995, significant increases are found. Yet those increases and the expenses associated with them are actually the result of business acquired in 1995 and thus either the 1995 expenses should be adjusted to reflect these

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increased expenditures or some adjustment should be made in estimating future expenses in the program off a base of 1994 or 1995.

GAO Excluded Expenses Are Reasonably Associated. Five specific expenses identified by GAO as "not reasonably associated with the sale and service of federal crop insurance" need to be addressed. These are 1) reinsurance costs; 2) acquisition costs of other companies; 3) management fees paid to parent companies; 4) bonuses paid to company employees; and 5) the use of corporate aircraft. **These expenses account for \$35 million of the \$43 million that were excluded by GAO over the 1994-95 period of study.** Focus on these expenses does not mean industry agrees with GAO's conclusions about others that were excluded.

(1) One of the goals of the crop insurance program is to make insurance easily accessible to farmers. An underlying desire is to also provide the farmer with some choice of companies to do business with even though the product is a standard one at a standard price. These goals are currently being met through the very competitive nature of the crop insurance business. Since companies do not compete on price, they compete on service. Farmers, taxpayers, and the government could not ask for a better system than this.

However, **financial capacity** is a central factor determining whether insurance will be available and from how many companies. Financial capacity in the insurance business is, in turn, influenced and augmented through the purchase of reinsurance. This is especially true in the crop insurance business as the underwriting returns over the years and the increased infrastructure investment required to keep pace with farmers' risk management needs have not permitted companies to build up "war chests" of capital reserves. The private sector would not have been able to help achieve the goals of the Reform Act through a near doubling the amount of premium written by private companies without commercial reinsurance. In addition, if and when premiums increase significantly due to higher crop prices, commercial reinsurance must fill the gap.

Minimum retention requirements, higher capital requirements, and limits on the distribution of underwriting gain imposed by FCIC itself in the SRA essentially require the purchase of commercial reinsurance as much a function enabling it to offer insurance to farmers as of protecting the company against potential underwriting loss. **While GAO highlights the underwriting gains earned over the years, it failed to mention that a bulk of these funds, on which the companies have paid taxes, are sitting in a reinsurance account in the U.S. Treasury indefinitely and the companies are not earning any interest nor have any access to those accounts.³** To the extent underwriting gains are accessible to the companies they serve a vital function — they increase the ability of private companies to take risk and make insurance available to producers. Thus, current procedures limiting gains act as a restraint on capacity, further necessitating and driving up the cost of commercial reinsurance.

³ Whether these accounts reduce the need for borrowing by the Federal Government and thus aid deficit reduction is not known. If they do, private companies should get credit for this contribution.

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Finally, the mere fact that reinsurance premiums must be paid whether or not there is an underwriting gain, clearly indicates that reinsurance premiums are an operating expense just as crop insurance is considered an operating expense by farmers. For all the foregoing reasons, commercial reinsurance expenses are a legitimate, necessary, and reasonable A&O expense. Therefore, \$10.7 million are reasonable and allowable expenses in 1994 and 1995.

(2) While GAO is correct that numerous consolidations and business acquisitions have occurred so as to lower the number of SRA holders, we disagree that all such acquisitions "provided no benefit to the sale and service of crop insurance" or that they were all motivated by the current companies' desire to maintain and increase market share. The majority of the acquisitions that have occurred over the years have been voluntary in that numerous companies decided they could no longer afford to stay in the MPC I business and wanted to get out. Reasons for these decisions have included poor management; increased government rules and regulations; the inability of small firms to meet the requirements of the federal government; excessive capital requirements; and high levels of retained risk.

Instead of simply dropping out of business and potentially leaving the FCIC to take over under the terms of the SRA, acquisitions and consolidations permitted policy holders to continue their insurance without interruption and minimized the potential for reduced program participation. This is a major benefit to the sale and service of crop insurance that was initiated not by corporate takeover strategies, but by the economics of delivering MPC I. Therefore, \$12.1 million are reasonable and allowable expenses in 1994 and 1995.

(3) A blanket statement that management fees paid to parent companies are not related to the sale and service of crop insurance is unfounded. It fails to recognize that without payment of such fees, as required, the company would not be delivering crop insurance. Treating such fees as a method of sharing income with the parent company is incorrect, as the fees would be due whether or not there was income. Therefore, \$1.1 million are reasonable and allowable expenses in 1994 and 1995.

(4) The report indicates that expenses resulting from sharing profits through bonuses are not reasonable expenses of the program. The manner in which a company chooses to motivate, reimburse and maximize the productivity of its employees, whether in the form of salary or salary plus potential for bonus, should not be an item of discussion for this report. Further, bonus structures typically are based on overall company profitability, which encompasses both operational efficiency and underwriting gain. Finally, it is quite likely that efficiencies normally attributed to economies of scale in more successful companies are in reality largely attributable to the motivation of those companies' employees, who are allowed to share in the company's success. According to GAO's discussion of this issue in the report, if these bonuses had been rolled into salary increases that had no relation to the profitability of the company in a given year, no criticism would have been made. This again ignores the nature of the crop insurance business and the fundamentals of business economics — providing salaries up front takes the risk that in a high loss year the company will be unable to provide the services needed or meet its payroll. Therefore, \$11.1 million are reasonable and allowable expenses in 1994 and 1995.

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See comment 18.

(5) A blanket condemnation of the use of corporate aircraft as excessive fails to recognize the ability of a company to make business judgements about the relative costs in terms of staff time and airfare in using a leased corporate aircraft versus commercial airlines. When several employees are traveling from one city to a rural area, it may well cost less to charter an aircraft and fly directly to the destination, rather than buy individual commercial tickets, rent a car, drive to the destination, stay overnight in a hotel, and repeat the process for the trip home. GAO's criticism of this practice ignores the fact that companies have an incentive to perform all of their responsibilities under the SRA in the manner they view to be most efficient, because if they are not, it is their own bottom line that suffers. What the GAO considers a luxury has proved to be an efficient business cost at the companies utilizing this practice. (No specific cost highlighted.)

See comments 3 and 9.

Emerging Factors Are Widely Speculative and Unreliable. The report notes that higher crop prices and increased premium rates as well as FCIC's efforts to simplify the program's administrative requirements are factors that help justify a reduction in the premium subsidy for A&O. As noted at the beginning of these comments, anyone with a rudimentary knowledge of agriculture in the United States knows that we cannot count on the high prices of today to be sustained year in and year out. Speculation about future crop prices should have no correlation to setting a sound A&O premium subsidy policy.

FCIC is also undertaking a thorough rate review. That review could result in decreases in rates as well as increases. **We trust FCIC will indicate the status of that report and its potential outcomes in its comments to the draft GAO report.**

See comment 19.

GAO Did Not Properly Evaluate FCIC Simplification and Regulatory Reduction. With respect to reductions in administrative requirements, the track record suggests that any assumption of decreased expense as a result of those efforts is etherial at best. **Despite the fact such reductions in administrative requirements are mandated by law, thus far FCIC has ignored two related requirements of the law and we have no reason to believe they won't do the same with this one.** In fact, FCIC personnel have been quoted as saying that this GAO report relieves them of any such requirement since expenses, according to this report, are already below those reduced rates provided for in the statute.

Section 508(b)(10) of the Act (7 U.S.C. 1508(b)(10)) required FCIC to create the catastrophic (CAT) program in as simple a manner as possible. FCIC blatantly ignored this mandate and made CAT more complex than the buy-up program. With direct relationship to Section 508(k)(5) of the Act (7 U.S.C. 1508(k)(5)) and the reduction of administrative and regulatory expense, FCIC has already failed to submit the report to Congress included in Section 118(c) of the Reform Act, the same general provision mandating this GAO report.

Furthermore, the majority of the simplification "achievements" contained in Appendix I of the draft GAO report principally serve as a basis for reducing FCIC's own budget, not the premium subsidy for A&O that the companies receive. The bulk of the cost-savings identified are being realized by RMA, not the companies. In addition, some of the actions indicated as a savings have actually resulted in significant costs to the companies, with respect to the issuance of the common policy. This has involved tremendous expense on the part of the companies and continues to do so.

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Finally, FCIC has developed a habit over the past three years of making substantial changes in the program in the middle of the year, just before sales closing, or at other times well after agent and adjuster training has been completed and computer programs have been finalized. This trend, which unfortunately doesn't appear to be ending, clearly indicates that any hope for administrative savings would be more than eaten up by the costs associated with these continued constant program changes. This is exemplified by the increase in Manager's, Research & Development, and other bulletins issued by FCIC over the past two years, many of which are revised again, that outline changes in or restatements of policy and procedure, notification of actuarial filings and new programs, and other matters:

	1995	1996
Manager's Bulletins	54	71
Research & Development Bulletins	54	81

Therefore, we believe it is wholly inappropriate for this report to use potential future reductions in administrative requirements in any manner as a basis for concluding that FCIC could lower reimbursements. There is simply no pattern or precedent to expect that FCIC will take such actions, nor is there a way to accurately quantify reductions in requirements, as the report admits in later pages.

Delivery Costs Must Be Properly Characterized. It is important to appropriately characterize the issue of administrative and operating costs, expense reimbursement, or premium subsidy for administrative and operating costs as the introduction and background sections of the Report are weak and not completely accurate in this regard. First and foremost, except for flood and crop insurance, every other line of insurance is expense loaded, meaning the administrative and operating (A&O) costs are included in the premium quoted and paid by the insured (for a list of A&O functions performed by private companies, please see Appendix II to these comments). However, for various public policy reasons, Congress designed the crop insurance program so that the government pays the entire administrative cost of the program from Federal agency oversight to sales to loss adjusting, whoever performs those tasks.

Therefore, the "fee" as GAO characterizes it, paid to private companies and agents for A&O is truly a premium subsidy to the insured and has always been so. In fact, the Federal Crop Insurance Reform Act of 1994 specifically amended the statute to characterize A&O as part of the premium and premium subsidy under Sec. 508 (d) and (e) (7 U.S.C. 1508(d) and (e)). The Standard Reinsurance Agreement was also subsequently amended to remove all references to "expense reimbursement" and properly characterizing such payments as simply "premium subsidy" or "premium subsidy attributable to administrative and operating expenses."

If the Administration or the GAO believe that the Federal government can no longer afford to pay the full cost of delivery, then it should straightforwardly so state and propose options for funding such costs via other means. Finally, to state that there is no requirement to spend the A&O premium subsidy on MPCl related items completely ignores the myriad of requirements imposed upon the companies through the SRA, its accompanying manuals, FCIC Manager and Research and Development bulletins, and other directives of the agency. Where is the money supposed to come from to pay agent commissions, loss adjustment expenses, training, printing of policies, etc.? If the

See comment 20.

See comment 21.

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final GAO report contains such a statement, it will truly be a sad commentary on the objectiveness of the analysis and its value to the public policy debate.

**PRIVATE MPC I DELIVERY COSTS LESS THAN GOVERNMENT DELIVERY
AND THAN OTHER LINES OF INSURANCE**
Principal Finding #2

Private Delivery is Less Costly Than FSA Delivery

The report's purported finding that the government's cost to deliver catastrophic insurance through USDA is less than through private companies is a blatant distortion of the very facts contained in the report. The report clearly denotes that the cost per policy for delivering CAT policies through private companies was \$83 whereas the cost through FSA was \$133 -- thus the government's cost of using FSA is 60% higher than using the private sector. This straight cost accounting does not even begin to reflect the exponentially superior service provided by the private sector. There are several OIG reports (i.e. Report Nos. 03801-1-SF; 03801-2-At; 03801-2-KC; 03801-11-Te; 03801-13-Te) that clearly indicate the woeful performance of FSA in adequately servicing the policies in their offices. This became very evident to the private sector when the transfer of policies occurred in the 14 states moved to single private delivery of CAT for the 1997 crop year. Addresses were missing, actual production histories (APHs) had not been done, all policies in the same county on the same crop had the same APH, the list goes on.

This is not to say many FSA employees didn't do a valiant job to get everyone enrolled within the time frame provided. However, it clearly shows that they are not trained insurance professionals and never will or should be. The government is not equipped to handle the crop insurance business without substantial increased investment. The anti-risk management culture prevalent throughout the FSA system can ill be afforded in the new risk environment facing agriculture under the new farm program. This culture is evidenced by the CAT policy retention numbers between 1995 and 1996 (only 70% - a drop of 35% in acreage insured) and the total lack of effort to preserve as many policies as possible in the 14-state transfer for the 1997 crop year.

Stellar Private Sector Performance Must Be Valued. The Statute Requires It. As noted earlier, Sec. 118(a) of the Reform Act required GAO to consider "the quality, costs, and efficiencies of providing the benefits of multiple peril crop insurance to producers of agricultural commodities." We believe that the best, most cost-effective, most efficient means for delivering Federally-subsidized crop insurance or other risk management tools is through private insurance companies and private insurance agents. We believe the evidence strongly supports this contention. The performance record of the private industry fulfilling this role speaks for itself, especially over the last three years, two of which are the subject of this report. American farmers and American taxpayers have reaped great benefits from private industry involvement in the crop insurance program that began in 1981.

The Federal Crop Insurance Reform Act of 1994 finally established crop insurance as the sole means of addressing crop disasters. Therefore, the performance of that program over the last two years should be closely examined and highly regarded. Farmer participation in 1996 is estimated at about 75 percent, almost as high as under the mandatory sign-up requirement of 1995.

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Record numbers of farmers are enjoying the benefits of buy-up protection as a result of professional risk management counseling by the private sector. The private sector has added nearly 500,000 policies to its books since 1994 plus handled the transfer of nearly 279,000 policies from the Farm Service Agency in 14 states for the 1997 crop year. A recent summary of business outlining the latest sales data for 1994-96 and highlighting the outstanding performance of the private sector is attached as Appendix III.

Another prime example of the significant value of private sector delivery was the private sector's ability to retain 94% of its 1995 CAT policies in 1996 after the program was no longer mandatory (a drop of only 5.6% in acres insured) as well as its 2.1% increase in buy-up sales at the same time (18,500 policies - 11% increase in acres insured). This generates tremendous savings to the federal government and helps achieve the fundamental goal of the crop insurance program -- participation. **In fact, even if private delivery did cost more than FSA delivery, the exponential differences in the service and work provided by the private sector would far outweigh whatever additional cost there might be.** Yet, this report totally ignores the performance record and clouds the delivery cost issue by incorporating underwriting gain.

All of this was accomplished with a lot of hard work, dedication, and investment in physical and human capital on the part of the private sector and its public partner. It was also accomplished with little disruption in service and few complaints by farmer-customers. **The GAO report complete ignores the high quality, efficient, and timely service to the farmer.**

Risk Management Education Put At Risk. The draft report fails to recognize the enormous role the private sector plays in educating and counseling farmers about risk management. Risk management education is a new buzzword in Washington and the Federal Agriculture Improvement and Reform (FAIR) Act of 1996 (P.L. 104-127) included a special provision emphasizing this effort. Furthermore, that same Act created a totally new risk environment for farmers with much more responsibility for managing risk placed on their own shoulders. Private companies and independent agents put on thousands of meetings for agricultural producers each year that provide these producers with the information they need to help assess their risks and then to manage them. This massive educational effort is potentially threatened by the severe reductions proposed in the GAO report, all at a time when more, not less education and counseling is needed.

CAT Fee Accounting is Misleading. Empirically, GAO's accounting of CAT fees is disingenuous. On the one hand, CAT fees are counted as revenue to the government. On the other, they are counted as an outlay of funds to companies. They cannot be both. Administrative fees paid by farmers are not an expense to the government and should not be considered as a cost of delivery. GAO states that companies are paid 24% of premium to deliver CAT that includes 9% attributable to the \$50 fees paid by farmers, not the government. The GAO counts them for the government and against the companies, then concludes that it costs more to deliver catastrophic coverage through the private sector.

Government Savings Result From High Performance. The report should also give credit -- to both FSA and the private sector -- for at least \$60 million or more in savings to the government over the past two years. Because the expanded crop insurance program was in place, two direct attempts to fund ad hoc disaster assistance were warded off. A specific \$41 million package of

See comment 23.

See comment 24.

See comment 25.

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assistance for cotton producers in 1995 was defeated on the floor of the U.S. Senate as were attempts to include crop disaster aid in 1996 legislation providing relief for Hurricanes Bertha and Fran.

No A&O Premium Subsidies Paid on CAT. The language throughout the report related to catastrophic insurance further confuses the public by stating that the private sector receives a reimbursement for delivery expenses. It does not. To quote Section III.A. of the SRA, "For CAT insurance contracts, FCIC will not provide a premium subsidy for administrative and operating expenses." Language in the report also insinuates that private companies get to retain administrative fees paid by the farmer in a different manner than does FSA. The fact is the rules are the same. Each can retain only \$100 per farmer per county and any remainder must be paid to the FCIC Fund.

What companies do receive for catastrophic policies is a reimbursement for loss adjustment expenses. This is paid as a percent of premium. Yet again, this is actually a subsidy to the farmer since they are getting the benefits of loss adjustment services at no cost to them.

Cost of Private MPCCI Delivery is Less Than Other Lines of Insurance

The clear, irrefutable evidence reveals that the rate paid to the private sector for selling and servicing MPCCI is at a greatly discounted rate compared to other lines of private insurance, thereby saving the government millions of dollars. According to data provided by A.M. Best, and relied upon by GAO, the 31% rate paid in 1994-96 for A&O premium subsidy for MPCCI delivery represents only about 40% of the cost of delivering private farmowner (property/casualty) policies. While this is not evident from the chart in the GAO draft report, it is evident from reviewing the entire chart (see Appendix IV) from which GAO excised the data due to three very important facts:

1) the figures presented in the A.M. Best tables are percentages of expense loaded premiums whereas the 31% rate paid in 1994 and 1995 for MPCCI was of non-expense loaded, pure-risk premium. If MPCCI premiums were expense loaded with 31% for A&O, the equivalent premium subsidy for A&O would only be 23.66%. GAO's adjusted 27% would be only 21.26% if it was calculated on the same basis as the A.M. Best data;

2) the loss adjustment expenses (LAE) were omitted from the table in the draft GAO report. Those expenses range from a ten-year average of 5.2% (also of expense loaded premium) to 30.7%. The ten year average for farmowners is 5.8%. Loss adjustment expenses for MPCCI are included **WITHIN** the basic A&O premium subsidy, scheduled to be not more than 28% in 1998, 27.5% in 1999. In 1994 and 1995, excess loss adjustment expense (XLAE) above this amount was available as well as special compensation in 1995, as noted in the report, due to massive midseason prevented planting changes. However, the historical rate paid has been less than 1% overall annually. Furthermore, USDA has maintained XLAE is no longer available; and

3) only one line of insurance, earthquake, has anywhere near the historic loss ratio, computed off of the higher expense loaded premium, of the crop insurance program. Therefore, the loss adjustment expenses of crop insurance would be far above average of the other lines given the 15-year average 1.23 loss ratio.

See comment 26.

See comment 7.

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Given the statutory requirement to reimburse private companies "at rates of compensation consistent with those generally prevailing in the insurance industry" within the other caps imposed by the statute, the above evidence supports an argument that FCIC would acting contrary to its own authorizing statute if it acted upon the recommendations contained in the draft GAO report.

Other Studies Confirm Government Savings Through Use of the Private Sector. Both this study and previous studies of the crop insurance program have shown that private sector delivery has saved the government millions of dollars compared with other forms of delivery that have been or could be used. The use of the private sector eliminates the government's need for commitment for overhead and other fixed costs. Companies and agents only get paid for policies in force, government employees get paid regardless. The private sector has historically delivered crop insurance at less cost than government delivery. Documentation of this has occurred several times, including a study commissioned by FCIC and performed by Arthur Andersen in September 1989, where industry costs were found to be 50% of FCIC's delivery costs. In this GAO report, industry's actual delivery costs were found to be only 62% of FSA delivery costs without any consideration of the much better service and additional work performed by the private sector. Finally, the results of various USDA delivery pilots, where costs sometimes approached 100% of premium and high policyholder cancellation rates were common, further argue for the private sector as the most cost-efficient and effective delivery system.

**GOVERNMENT IS REAPING SAVINGS UNDER CURRENT A&O
PREMIUM SUBSIDY SYSTEM**
Principal Finding No. 3

In reviewing this report, it is extremely frustrating to industry that there is no recognition whatsoever that government costs in 1997, 1998, and 1999 will already be lower as a natural function of the existing statute and changes included in the reinsurance agreement governing recently expanded revenue insurance pilot projects. Even in the background discussion of the premium subsidy for A&O on pages 2 and 18 of the draft report, a clear picture of the downward trend of that subsidy is not portrayed. Appendix V illustrates the reimbursement trend compared with the workload trend under the program and Appendix VI shows a rough, conservative estimate of government savings/losses to the private sector under current law.

The finding or conclusion that alternative reimbursement arrangements offer potential for savings again ignores the savings inherent in the current system and the failure of GAO to understand the value and operation of that system. Additionally, the statement that an alternative system would encourage more service to smaller farmers than does the current system is also objectionable in that it carries a strong connotation that the private sector currently discriminates against smaller farmers. GAO's own table 4.1 clearly indicates that 70% of 1995 policies were below \$1,000 in average premium and industry received only \$66 per policy (less than the delivery cost identified for CAT policies) on 43.6 percent of policies. Absent any other evidence to the contrary, we would strongly argue that the current system provides sufficient incentive to serve smaller farmers.

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Alternative 1. Capping premium subsidy per policy. While A&O premium subsidies on the largest policies are significant, they cannot be viewed in a vacuum. First, some larger policies can involve significantly more handling due to the number of units included, the likelihood of high risk land being involved, more complex APH computations, and a number of other factors. Second, as the data in Table 4.1 shows, the vast majority of policies return less than \$280 each and many return less than \$75. Further, as this report indicates, the average cost per policy is above this level. Therefore, without cross-subsidization of the "significant" reimbursements from very large policies, financial stress and instability would result. One would actually create an incentive not to service smaller policies. No guidance is given on what type of cap might be implemented nor whether there would be a "cup" or minimum payment for smaller policies to balance the imposition of the cap, thereby making it difficult to evaluate and comment more comprehensively.

See comment 32.

Alternative 2. Pay a minimum plus a percent of premium. The evidence clearly indicates that companies are significantly underpaid on a large number of policies which the payment of a minimum A&O premium subsidy would rectify. However, this approach ignores the savings generated by the current competitive system and could drive up costs by inducing the proliferation of policies. While commonplace in other forms of government procurement arrangements, this is inefficient and should be avoided. As noted above, there are points of no return. Incentives must be built to keep people involved in the program to maintain farmer participation and adequately meet their risk management needs. This approach would have a devastating impact on agents writing in certain areas of the country as well as companies handling crop policies with higher than average administrative costs.

See comment 33.

Alternative 3. FAR accounting. This would be an administrative nightmare, driving up administrative costs as opposed to generating savings. Our opening comments clearly indicate the bulk of the industry's feelings about this type of system and the advisability of adopting it. The current management has a hard enough time handling the current system and claim they need 43 additional personnel to service their private sector partners. One could triple that amount of people if a FAR system were adopted. The benefits, if any, would be far outweighed by the costs.

See comment 34.

Alternative 4. Reduce reimbursement rates as premium volume increases. There is no evidence contained in the draft report indicating that the expenses of a company vary by company size or premium volume. That was one of the issues Congress asked to be addressed but it is not in this report. This type of arrangement could be simply circumvented by breaking a company up into smaller entities at such levels to maximize A&O premium subsidy. This proposal would also discourage larger companies, who provide service to the greatest number of farmers, from aggressively participating in the delivery of the program. The implications that only three companies out of 19 would be affected by such a proposal is irrational, as those companies, given their premium volume, are the ones with the most policyholders.

See comment 35.

Other alternatives exist. Options such as allowing companies to take A&O from farmer paid premium, the surcharging of premium to make up for insufficient premium subsidies, rolling LAE into the loss ratio as it is done in other lines of service, paying actual loss adjustment costs separately from other A&O, and other ideas have been discussed in this regard. Industry would be glad to work with the Comptroller General, FCIC, the Congress, farm groups, and other interested parties to examine these in greater detail if the current system must be changed. However, we

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remain unconvinced at this point that any other system will provide the cost savings and high performance that the current one does.

One thing is also clear, if FCIC takes the GAO's advice and lowers A&O premium subsidies below the current statutory limits, something has to change. Either the work required to be done under the program and SRA or the type, method, timing or other aspects of providing A&O premium subsidy must be altered if American farmers are to receive the level of service and protection that they deserve. Any change from the current system must be thoroughly studied taking into account the ramifications at every step and level of the insurance cycle for all parties involved.

CONCLUSION: Private Sector Involvement Should Increase

Given the success of program delivery by the private sector, as borne out by: record farmer participation; reduced costs compared to government delivery; negligible customer dissatisfaction with service; and the elimination of other, more costly disaster assistance programs, we suggest and strongly recommend that the next steps be taken to expand the private sector's responsibilities in the program. This would involve identifying functions still performed by FCIC which could be more efficiently performed by the private sector, leaving government in the role of administrator, regulator, and reinsurer. It would also mean, as noted in the draft report, that the Secretary should move forward expeditiously to transfer all remaining FSA delivery of catastrophic protection to the private sector.

The intention of the 1990 amendments to the Federal Crop Insurance Act was for government to expand the experiment begun in 1980 from merely delivery of the program to include other functions that would utilize the expertise and efficiencies of the private sector. In fact, there is a statutory mandate to do so contained in Section 507(c)(2) of the Federal Crop Insurance Act (7 U.S.C. 1507(c)(2)). Expanding the role of the private sector could allow elimination of costly government duplication, permit agency downsizing and would truly be in the spirit of "reinventing government," the message and effect of which has yet to trickle down to the Risk Management Agency and Federal Crop Insurance Corporation.

We regret that the GAO, and apparently, FCIC chose not to abide by the Congressional mandate contained in Section 118 of the Reform Act. Had they conducted the comprehensive analysis called for, they would have found the quality of private performance to be high, they would have found the costs of private delivery lower than those of the government system and lower than other lines of insurance, and they would have found the efficiencies of the private sector second to none. These findings and conclusions would lead to a recommendation to the Secretary of Agriculture and to Congress to increase the role of the private sector in the Federal crop insurance program, not threaten the entire stability of the delivery system by an unwarranted and speculative cut in the premium subsidy paid for administrating and operating expenses.

APPENDIX I	-	Unique Characteristics of Crop Insurance
APPENDIX II	-	Functions Performed by Reinsured Companies
APPENDIX III	-	Summary of Business
APPENDIX IV	-	A.M. Best's 10-year averages including LAE
APPENDIX V	-	Chart of increased workload and decreasing reimbursement
APPENDIX VI	-	Rough estimation of cost reductions under current statute

See comment 37.

See comment 38.

APPENDIX I

**Unique Characteristics of Federal Crop Insurance
From a Private Reinsured Company Perspective**

A. Crop insurance losses are generally catastrophic in nature. The Federal policy is a multiple peril policy covering losses from drought, flood, disease, hail, etc. Generally, a drought or flood is unlikely to affect just one farm -- it affects an entire community. Thus, losses can be catastrophic in nature. The 1993 Midwest floods, 1996 Hurricanes Bertha and Fran, and 1996 Southwest drought are good examples.

B. Premiums are not due from farmers until the end of the insurance period. Most lines of insurance have up front payments or installment plan payments. Therefore, the crop insurance companies do not have any premium income to invest and earn investment income from during the insurance period and into the claims period.

C. All administrative costs are reimbursed by the government -- farmer paid premiums are risk-based only. The rate for reimbursement is being ratcheted down -- 31% in 1996, 29% in 1997, 28% in 1998, 27.5% in 1999. Note that these are statutory maximum rates and the Administration's Fiscal Year 1998 Federal Budget proposes paying a reimbursement rate of only 24.5% -- a 20% reduction from the 1996 level and 12.5% lower than the already reduced 28% rate set for 1998. Also, these reimbursements are paid in installments, the first of which is not paid until actual acreage is reported -- as much as 5 months after sales are completed and the second of which does not come until the end of the insurance period when the premium is due.

D. Companies don't actually know their exposure until around five months after the sales closing date for insurance in that farmers only pay premium on planted acreage which is reported through the agent by set dates for various crops.

E. Premiums are not steady in that they are tied to the market value of the crop and acreages can vary from year to year. For example, the indemnity rate for corn was \$2.25/bushel in 1995, \$2.65/bu. in 1996, and back down to \$2.45/bu. in 1997. Also, in 1995 under the farm program farmers could not plant 7.5% of their base acres to corn thereby restricting premium on corn. In 1996, acreage reduction programs were eliminated and farmers are now free to plant almost any crop fence row to fence row. However, shifts in production and thus premiums are now potentially more volatile and more difficult to predict.

F. All rates are set by the government and the law has built in restrictions on how much they can be increased in any given year. Therefore, even if industry identifies a severe inadequacy, it cannot directly change it. A company's only option is to place policies subject to inadequate rates in an Assigned Risk Fund in which the companies bear a minimum amount of risk under the reinsurance agreement with the government.

Unique Characteristics of Federal Crop Insurance

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G. Companies are required to submit plans of operation for the upcoming crop year outlining premium retention levels 3 to 8 months prior to knowing crop prices and 7 to 14 months before the actual liability levels are known. Little opportunity exists to alter this plan even when the government changes procedures, price elections, or policy provisions that may increase administrative costs and underwriting risks.

H. There is no contract change clause in the Standard Reinsurance Agreement that governs the financial relationship between the private companies and the government. In other words, the government can impose new administrative or regulatory requirements or impose increased underwriting risks on the companies and the expense reimbursement does not change nor are the companies provided an opportunity to alter the risk sharing arrangement mid-stream. All added costs have to be absorbed. This obviously affects the companies' ability to structure private reinsurance agreements.

I. The amount of underwriting gains earned by companies that may be distributed to the company are limited by the Standard Reinsurance Agreement. Earnings over the limit of 15% are placed in a reinsurance account indefinitely to be applied against future underwriting losses. No interest is paid on the balances held in the reinsurance account. Companies are required to pay state and Federal taxes on these gains in the year earned, despite the fact they don't have access to the funds.

J. The Standard Reinsurance Agreement is an annual agreement that may or may not be extended. Due to the uncertainty of extension of the agreement, private reinsurers are also hesitant to make longer term commitments to this program.

K. Due to the fact that government money is used to pay for the delivery of MPCI, some marketing and operational practices that are commonplace in the insurance industry and which make good business sense -- i.e., agent incentives and employee bonuses -- are heavily scrutinized.

L. In the mid-1980s there were as many as 56 different companies involved in the crop business. In 1997, the number of companies holding Standard Reinsurance Agreements is only 16. This is reflective of the complexity, cost, and minimal returns experienced in the program over the years.

M. Claims are required to be paid within 30 days or an explanation given as to why they can't be paid within that time.

N. In most instances, premiums are not paid on policies which have associated claims filed on them -- the premium is withheld (with any interest due) from indemnities. Thus here again, the companies do not have the ability to invest premiums even during the claims period.

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APPENDIX II — FUNCTIONS PERFORMED BY REINSURANCE COMPANIES

Underwriting and Processing

APH Field Reviews
Fund Underwriting
Verification of Premium and Coverage Data
Process Applications
Process, Verify and Approve APH
Policy Issuance
Acreage Report Processing
Issue Summaries of Coverage
Process and Approve Revised Late Acreage Reports
Process LPO's, FCI-2's, Assignments, etc.
Premium Billing
Premium Collection
Process Terminations
Quality Control Over Underwriting and Processing
FCIC Reporting

Claims

Adjuster Training
Claims Audit
Verification of Claims Data
Pay Adjuster Expenses
Forms Production and Distribution
Claims Supervision
Adjuster Recruitment
Claim Related Litigation
Loss Notice Processing
Claims Payment Processing
Escrow Account Administration
Adjuster Licensing
1099 Processing
Adjust Claims
Quality Control

Marketing, Education, & Sales

Public Information & Education on Value of Crop Insurance
Agent Commissions
Agent Recruitment
Agent Training
Advertising
Agent Licensing
Educate providers of credit how to use crop insurance to
provide & secure agricultural credit
Audit of Marketing Activity
Reproduction/distribution of actuarial documents
Production of Forms, Materials
Distribution of Forms, Material
1099 Processing
Oversee Servicing by Licensed & Approved Agents
Quality Control

Other

Litigation
Corporate Insurance
Rate and Policy Filing
Financial Standards/Reserves/Reinsurance
Data Reporting/ADP Expenses
Company Licensing
Filing Annual Statements
Income Taxes
State Solvency Assessments
Punitive Damages
Cash Flow/Borrowing Costs
Payment of Uncollected Premiums
Broker costs
Post Hoc Program Changes - Underwriting & Administration
Salaries and Wages/Employee Benefits/Payroll Taxes
Misc. Overhead

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Appendix III - Federal Crop Insurance - Summary of Business Report as of 3/17/97								
	1994	1995	GROSS	PERCENT	1996	GROSS	PERCENT	PERCENT
	CROP YEAR	CROP YEAR	CHANGE	CHANGE	CROP YEAR	CHANGE	CHANGE	CHANGE
	TO DATE	TO DATE	1994-95	1994-95	TO DATE	1995-96	1995-96	1994-96
ADDITIONAL BUSINESS								
POLICIES WITH PREM.	813,263	865,359	52,096	6.41%	883,868	18,509	2.14%	8.68%
UNITS WITH PREM.	1,819,397	1,997,299	177,902	9.78%	2,125,267	127,968	6.41%	16.81%
Avg. Units/Policy	2.24	2.31	0.07	3.17%	2.40	0	4.18%	7.48%
NET ACRES INSURED	99,644	105,332	5,688	5.71%	116,701	11,369	10.79%	17.12%
Avg. Acres/Policy	122.52	121.72	-0.80	-0.66%	132.03	10	8.47%	7.76%
LIABILITY	13,597,587	15,281,065	1,683,478	12.38%	19,138,940	3,857,875	25.25%	40.75%
Avg. Liability/Policy	16,719.79	17,658.64	939	5.62%	21,653.62	3,995	22.62%	29.51%
TOTAL PREMIUM	948,904	1,086,584	137,680	14.51%	1,396,451	309,867	28.52%	47.16%
Avg. Premium/Policy	1,166.79	1,255.65	89	7.62%	1,579.93	324	25.83%	35.41%
SUBSIDY	254,729	433,061	178,332	70.01%	547,651	114,590	26.46%	114.99%
Avg. Subsidy/Policy	313.22	500.44	187	59.77%	619.61	119	23.81%	97.82%
INDEMNITY	594,186	1,396,348	802,162	135.00%	1,289,841	-106,507	-7.63%	117.08%
Avg. Indemnity/Policy	730.62	1,613.61	883	120.85%	1,459.31	-154	-9.56%	99.74%
LOSS RATIO	0.63	1.29	0.66	103.98%	0.92	-0.36	-28.12%	46.61%
REINSURED CATASTROPHIC BUSINESS								
POLICIES WITH PREM.	0	367,735	367,735		297,641	-70,094	-19.06%	N/A
UNITS WITH PREM.	0	528,206	528,206		433,912	-94,294	-17.85%	
Avg. Units/Policy	0.00	1.44	1.44		1.46	0.02	1.49%	
NET ACRES INSURED	0	41,584	41,584		39,267	-2,317	-5.57%	
Avg. Acres/Policy	0.00	113.08	113.08		131.93	19	16.67%	
LIABILITY	0	3,112,503	3,112,503		3,560,651	448,148	14.40%	
Avg. Liability/Policy	0.00	8,463.98	8,464		11,962.90	3,499	41.34%	
TOTAL PREMIUM	0	175,168	175,168		214,481	39,313	22.44%	
Avg. Premium/Policy	0.00	476.34	476		720.60	244	51.28%	
INDEMNITY	0	62,183	62,183		57,387	-4,796	-7.71%	
Avg. Indemnity/Policy	0.00	169.10	169		192.81	24	14.02%	
LOSS RATIO	0	0.35	0		0.27	-0.09	-24.63%	
FSA CATASTROPHIC BUSINESS								
POLICIES WITH PREM.	0	807,109	807,109		433,287	-373,822	-46.32%	N/A
UNITS WITH PREM.	0	1,170,472	1,170,472		638,385	-532,087	-45.46%	
Avg. Units/Policy	0.00	1.45	1.45		1.47	0	1.60%	
NET ACRES INSURED	0	73,727	73,727		47,722	-26,005	-35.27%	
Avg. Acres/Policy	0.00	85.20	85.20		110.14	25	29.27%	
LIABILITY	0	5,330,016	5,330,016		3,890,203	-1,439,813	-27.01%	
Avg. Liability/Policy	0.00	6,159.31	6,159		8,978.35	2,819	45.77%	
TOTAL PREMIUM	0	281,180	281,180		208,433	-72,747	-25.87%	
Avg. Premium/Policy	0.00	324.93	325		481.05	156	48.05%	
INDEMNITY	0	105,118	105,118		86,914	-18,204	-17.32%	
Avg. Indemnity/Policy	0.00	121.47	121		98.33	-23	-19.05%	
LOSS RATIO	0	0.37	0		0.42	0	12.35%	
COMBINED BUSINESS								
POLICIES WITH PREM.	813,263	2,040,203	1,226,940	150.87%	1,614,796	-425,407	-20.85%	98.56%
UNITS WITH PREM.	1,819,397	3,695,977	1,876,580	103.14%	3,197,564	-498,413	-13.49%	75.75%
Avg. Units/Policy	2.24	1.81	-0.43	-19.02%	1.98	0	9.31%	-11.49%
NET ACRES INSURED	99,644	220,643	120,999	121.43%	203,690	-16,953	-7.68%	104.42%
Avg. Acres/Policy	122.52	108.15	-14.38	-11.73%	126.14	18	16.64%	2.95%
LIABILITY	13,597,587	23,723,584	10,125,997	74.47%	26,589,794	2,866,210	12.08%	95.55%
Avg. Liability/Policy	16,719.79	11,628.05	-5,092	-30.45%	16,466.35	4,838	41.61%	-1.52%
TOTAL PREMIUM	948,904	1,542,932	594,028	62.60%	1,819,365	276,433	17.92%	91.73%
Avg. Premium/Policy	1,166.79	756.26	-411	-35.18%	1,126.68	370	48.98%	-3.44%
SUBSIDY	254,729	889,409	634,680	249.16%	970,565	81,156	9.12%	281.02%
Avg. Subsidy/Policy	313.22	435.94	123	39.18%	601.04	165	37.87%	91.89%
INDEMNITY	594,186	1,563,649	969,463	163.16%	1,434,142	-129,507	-8.28%	141.36%
Avg. Indemnity/Policy	730.62	766.42	36	4.90%	888.13	122	15.88%	21.56%
LOSS RATIO	0.63	1.01	0		0.79	-0.23	-22.22%	25.88%
* NOTES: ACRES AND DOLLARS IN THOUSANDS, ALL CATASTROPHIC PREMIUM IS 100% SUBSIDIZED.								
THIS REPORT REFLECTS ONLY THOSE POLICIES WITH ACREAGE/LOSS DATA								

Analysis Provided by AACI

Sobapp

Source: FCIC/RMA

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APPENDIX IV				
Comparison of 1994 and 1995 Adjusted Buyup Insurance Delivery Expenses As a Percent of Premium to 10-Year Average Expenses for Other Property & Casualty Insurance Lines As a Percent of Premium, Sorted by Total Expenses				
Delivery expenses as a percent of premium - 10 yr. avg.				
Line of Insurance	Commission Expenses	All Other Admin. Expenses	Loss Adjustment Expenses	Total Expenses
GAO's Max. Recomm. Expense Loaded				19.35
1998 Maximum Rate Expense Loaded				21.875
Group accident and health	8.1	9.3	4.9	22.3
1994-96 Rate Paid, Expense Loaded				23.66
GAO's Maximum Recommendation				24.0
Administrations FY98 Budget Proposal				24.5
1995 Buyup (GAO Adjusted 9-co. total)	16.2	10.9	Inc. in All Other	27.1
1994 Buyup (GAO Adjusted 9-co. total)	16.0	11.5	Inc. in All Other	27.5
1998 Statutory Maximum Rate				28.0
Private passenger auto physical damage	8.6	13.9	8.4	30.9
1994-96 Rate Paid				31.0
Workers' compensation	5.4	13.9	11.7	31.0
Other lines	6.9	20.4	4.2	31.5
Reinsurance	20.1	6.1	6.2	32.4
Other accident and health	13.0	16.5	5.4	34.9
Personal lines	10.0	14.2	11.2	35.4
Private passenger auto liability	8.5	14.1	13.0	35.6
Aircraft	14.4	14.1	8.1	36.6
Commercial auto physical damage	15.1	14.9	6.7	36.7
Total all lines	11.2	14.8	12.5	38.5
Fidelity	13.0	19.3	7.3	39.6
Allied lines	15.1	17.6	7.4	40.1
Farmowners multiple peril	16.6	15.1	8.8	40.5
Commercial lines	12.3	15.2	13.8	41.3
Commercial auto liability	13.3	15.2	13.0	41.5
Ocean marine	19.1	14.4	8.0	41.5
Homeowners multiple peril	16.1	14.9	11.2	42.2
Burglary and theft	14.6	22.7	5.2	42.5
Fire	17.3	20.0	5.2	42.5
Inland marine	17.5	19.5	5.7	42.7
Earthquake	13.8	16.2	14.3	44.3
Medical malpractice	3.9	11.3	30.7	45.9
Commercial multiple peril	17.4	18.3	15.9	51.6
Boiler and machinery	11.5	35.8	5.0	52.3
Other liability	11.0	14.5	27.7	53.2
Surety	19.1	28.9	9.6	57.6
Source: Best's Aggregates & Averages -- Property/Casualty				
Important Notes:				
Loss Ratios for 1994 & 1995 Buyup are actual loss ratios for all writers. 15-yr. avg. is 123. Target is 107.5.				
Personal lines include Private Passenger Auto and Homeowners Multiple Peril;				
Commercial lines data includes all other lines, including Earthquake.				
Other lines includes Glass, Credit, Mortgage Guaranty, International, and Misc.				

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APPENDIX V — SELECTED FCIC PROGRAM CHANGES AND DATA PROCESSING REQUIREMENTS - 1991-1996

A&O Premium Subsidy	Change				
Year	Rate	Change From '91			
1988-91	34%				
1992	33	-2.9%			
1993	32.5	-1.5%			
1994-96	31	-4.6% -8.8%			
1997	29	-6.45% -14.7%			
1998	28	-3.45% -17.65%			
1998 GAO	24 or less	-17.2% -29.4%			
1999	27.5	-1.79% -19.1%			
			<i>Prevented Planting Change</i>	<i>Prevented Planting Change</i>	<i>Prevented Planting Change</i>
			<i>New CAT Program (late)</i>	<i>New CAT Program (late)</i>	<i>New CAT Program (late)</i>
			<i>Reformed Buyup Program</i>	<i>Reformed Buyup Program</i>	<i>Reformed Buyup Program</i>
			<i>Revise SBI</i>	<i>Revise SBI</i>	<i>Revise SBI</i>
			<i>Common Policy</i>	<i>Common Policy</i>	<i>Common Policy</i>
			<i>Agent/Adjuster Tracking</i>	<i>Agent/Adjuster Tracking</i>	<i>Agent/Adjuster Tracking</i>
			<i>Modified APH</i>	<i>Modified APH</i>	<i>Modified APH</i>
			<i>Policy Holder Tracking</i>	<i>Policy Holder Tracking</i>	<i>Policy Holder Tracking</i>
			<i>SBI Required</i>	<i>SBI Required</i>	<i>SBI Required</i>
			<i>SSN/EIN Required</i>	<i>SSN/EIN Required</i>	<i>SSN/EIN Required</i>
			<i>NCS to Counties</i>	<i>NCS to Counties</i>	<i>NCS to Counties</i>
			<i>w/1.10 LR</i>	<i>w/1.10 LR</i>	<i>w/1.10 LR</i>
			<i>Prevented Planting</i>	<i>Prevented Planting</i>	<i>Prevented Planting</i>
			<i>GRP to 7 Crops</i>	<i>GRP to 7 Crops</i>	<i>GRP to 7 Crops</i>
			<i>GRP</i>	<i>GRP</i>	<i>GRP</i>
			<i>Change in D.P. Assigned</i>	<i>Change in D.P. Assigned</i>	<i>Change in D.P. Assigned</i>
			<i>Risk Designation</i>	<i>Risk Designation</i>	<i>Risk Designation</i>
			<i>LPO Premium</i>	<i>LPO Premium</i>	<i>LPO Premium</i>
			<i>Modifications</i>	<i>Modifications</i>	<i>Modifications</i>
			<i>35% Coverage Level</i>	<i>35% Coverage Level</i>	<i>35% Coverage Level</i>
			<i>Mandatory</i>	<i>Mandatory</i>	<i>Mandatory</i>
			<i>Telecommunications</i>	<i>Telecommunications</i>	<i>Telecommunications</i>
			<i>NCS to 7 Crops</i>	<i>NCS to 7 Crops</i>	<i>NCS to 7 Crops</i>
			<i>SSN/EIN Format</i>	<i>SSN/EIN Format</i>	<i>SSN/EIN Format</i>
			<i>Requirements</i>	<i>Requirements</i>	<i>Requirements</i>
			<i>New Data Processing</i>	<i>New Data Processing</i>	<i>New Data Processing</i>
			<i>Records</i>	<i>Records</i>	<i>Records</i>
			<i>SRA-Restructure</i>	<i>SRA-Restructure</i>	<i>SRA-Restructure</i>
<i>Non-Std. Classification</i>	<i>Non-Std. Classification</i>	<i>Non-Std. Classification</i>	<i>Non-Std. Classification</i>	<i>Non-Std. Classification</i>	<i>Non-Std. Classification</i>
<i>Market Price Election</i>	<i>Market Price Election</i>	<i>Market Price Election</i>	<i>Market Price Election</i>	<i>Market Price Election</i>	<i>Market Price Election</i>
<i>APH Verification</i>	<i>APH Verification</i>	<i>APH Verification</i>	<i>APH Verification</i>	<i>APH Verification</i>	<i>APH Verification</i>
1991	1992	1993	1994	1995	1996

Appendix IX
Comments From the American Association
of Crop Insurers and the Crop Insurance
Research Bureau, Inc.

Appendix VI											
Rough Ballpark Estimate of Delivery Expense Reductions & Impact of Proposed Budget Cut											
Buy-up Policies	Acres	% of Total	Premium	% of Total	Price* Change '97	Est. Change in Premium	96 A&O	97 A&O	1997 Cut	Proposed 24.50% On '97 Prem	A&O Change From '96
Corn	25,761,067	22.04%	313,302,326	22.40%	-7.55%	(23,645,459)	97,123,721	84,000,492	(13,123,230)	70,965,933	(26,157,789)
CRC Corn	7,662,106	6.56%	108,667,578	7.77%	-6.60%	(7,176,511)	33,686,949	25,372,767	(8,314,182)	24,865,311	(8,821,638)
Soybeans	19,830,747	16.97%	175,294,634	12.53%	-8.89%	(15,581,745)	54,341,337	46,316,738	(8,024,599)	39,129,658	(15,211,679)
CRC Beans	3,484,404	2.98%	30,516,740	2.18%	1.36%	415,330	9,460,189	7,733,017	(1,727,172)	7,578,357	(1,881,832)
Cotton	6,653,148	5.69%	199,140,083	14.24%	0.00%	-	61,733,426	57,750,624	(3,982,802)	48,789,320	(12,944,105)
Wheat	37,797,436	32.34%	233,191,868	16.67%	8.45%	19,706,355	72,289,479	73,340,485	1,051,006	61,960,065	(10,329,414)
Sorghum	5,938,520	5.08%	57,813,006	4.13%	-8.00%	(4,625,040)	17,922,032	15,424,510	(2,497,522)	13,031,052	(4,890,980)
Total Above	107,127,428	91.67%	1,117,926,235	79.92%		(30,987,070)	346,557,133	309,938,632	(36,618,501)	266,319,695	(80,237,437)
Other Crops	9,731,572		280,884,765			?	87,074,277	81,456,582	(5,617,695)	68,816,767	(18,257,510)
Total U.S.	116,859,000		1,398,811,000			1,367,983,930	433,631,410	391,395,214	(42,236,196)	335,136,463	(98,494,947)
Percent Change									-9.74%		-22.71%
Assumptions:											
1997 premium on other crops remains at 1996 level.											
1997 A&O Rate of 29%											
1997 Acreage Remains Constant from 1996											
No Assumptions Made About CRC Expanded Premium -- could result in more premium & A&O, but not \$42 million worth.											
No Rate Changes											
							Change Post 5	Revised			
	CRC	97 Price	96 prices	Change			Rate Surcharge	A&O Rate			
	Corn	2.59	2.93	-11.6%			-6.6%	25%			
	Beans	6.62	6.87	-3.6%			1.4%	25%			

AACI

3/25/97

Data as of 1/27/97, Accuts

GAO's Comments

1. The 1994 reform act mandated that GAO and FCIC jointly evaluate the current financial arrangement between FCIC and approved insurance providers for delivering multiple-peril crop insurance to farmers. In researching the legislative history of this provision, we found that the paramount congressional interest was in controlling the costs of reimbursing crop insurers in the context of funding this and other agricultural programs in a deficit reduction environment. Moreover, we confirmed our interpretation of the mandate in a commitment letter to the Chairmen and Ranking Minority Members of the Senate Committee on Agriculture, Nutrition, and Forestry, and the House Committee on Agriculture at the outset of our review. This letter set forth our approach for meeting this mandate, including our scope and methodology. We believe that the report fulfills the mandate.

2. We used 1994 and 1995 data for our analysis because these 2 years provide a picture of expenses for delivering crop insurance before and after the implementation of the reform act. Because of industry concerns expressed early in our review about the use of this 2-year period, we considered the extent to which loss-adjusting expenses may change with varying loss experience as well as the extent to which loss-adjusting expenses may affect total administrative expenses. We found that high crop losses did not significantly increase companies' loss-adjusting expenses—the delivery cost factor most likely to be affected by high crop losses. For example, for buyup insurance, while companies paid out \$1.28 in loss claims for every dollar of premium received in 1995 and \$0.58 in loss claims for every dollar of premium received in 1994, their related loss-adjusting expenses as a percent of premium for these 2 years were not substantially different. Therefore, although losses were higher in 1995 than in 1994, the companies' loss-adjusting expenses for processing these claims did not increase commensurately. In addition, loss-adjusting expenses are not a significant portion of total administrative expenses (about 3.5 percent of premiums on average for the nine companies we reviewed). Furthermore, since the 1980s, the crop insurance companies have received additional reimbursements in years of high crop losses.

The draft report's reference to 1995 as a year of relatively low crop losses was intended to reflect a low level of catastrophic loss claims. Because this reference was apparently confusing, we have deleted it from the final report. In actuality, the loss ratio on buyup coverage in 1995 exceeded the loss ratio in 1990 and 1992 and was about the same as the loss ratio in 1991. Only in 1993, the year of a one-in-100-year flood event, was the loss ratio substantially higher.

3. Our analysis is based on actual company expenditures in 1994 and 1995 and actual crop price information for 1996 and 1997. We did not specifically address future crop prices. However, USDA's World Agricultural Outlook Board projects generally increasing prices through 2005. If crop prices decline, FCIC could reevaluate the reimbursement rate for administrative expenses.

4. This assertion is not correct. As we noted in our report, the FAR was just one of several sources we used to develop criteria for identifying expenses reasonably associated with selling and servicing crop insurance. We recognized all expenses reasonably associated with selling and servicing crop insurance. However, we continue to believe that the taxpayer should not be expected to reimburse companies for such expenses as those related to maximizing underwriting gains, acquiring other companies' business, paying executives to refrain from joining or starting other companies, paying parent companies management fees without receiving any measurable benefits for the program, providing profit-sharing bonuses, and paying lobbying expenses. We believe that these expenses should not be included in determining an appropriate future reimbursement rate for administrative expenses.

5. Contrary to the industry's assertion, we believe that the reimbursement for administrative expenses is just that. It is intended to reimburse companies for the costs of selling and servicing crop insurance, not to provide an additional source of profit to the industry. While FCIC encourages the companies to provide competitive service within the reimbursement rate provided, FCIC expects, as evidenced by the standard reinsurance agreement, that the profits companies seek should come from underwriting gains, not from the administrative reimbursement. In fact, since 1990, companies have earned over \$0.5 billion in net underwriting gains.

6. While an evaluation of the quality of service provided by the companies and USDA was not a principal focus of our review, we found little to suggest that the quality of service by companies and USDA to farmers was unsatisfactory.

7. Contrary to the industry's assertion, we did not use the information in appendix VII to arrive at our conclusion of an appropriate reimbursement rate for delivering federal crop insurance; we presented this information only because it was required by the 1994 reform act. In this appendix of our draft report, we inadvertently omitted the loss-adjusting expenses

associated with commercial insurance lines in our presentation of commercial lines of insurance expenses in relation to the expenses of government-sponsored multiple-peril crop insurance. In response to the industry's observation on this omission, we revised the appendix to include reported loss-adjusting expenses.

We did not use this information for our analysis because the percentages presented do not provide an appropriate comparison between commercial lines of insurance and government-sponsored multiple-peril crop insurance for several reasons. First, the expense ratios for commercial lines are based on premiums that include both risk and expense factors, while the expense ratios for multiple-peril crop insurance are based on premiums that include only a risk factor. Second, we did not verify the ratios for the commercial lines of insurance and hence we cannot speak to the accuracy of the cost elements that have been included in the computations of those ratios. Finally, premium rates for commercial insurance lines are significantly lower than average rates for multiple-peril crop insurance. As a result, if a comparison to other lines of insurance is to be made, the only appropriate comparison is on a dollars-per-policy basis, not on a percentage-of-premium basis. Although expenses as a percent of premium may appear to be much higher for several commercial lines, the amount of expense dollars involved per policy is actually less than for government crop insurance.

If we examine the dollars paid per policy instead of the percentage of premium per policy, the reimbursement for multiple-peril crop insurance per dollar of premium substantially exceeds the reimbursement for other lines. For example, in 1995, according to NAIC, the average consumer payment for private passenger automobile insurance was \$666 per vehicle, and the reported delivery expense rate was as much as 35.6 percent, or \$237. In comparison, for 1995 buyup crop insurance, the average premium was \$1,905 per policy, and the 31-percent reimbursement rate resulted in an average payment to crop insurance companies of \$591—or about 2.5 times more than the dollar value of delivery expenses for private passenger automobile insurance. If the reimbursement rate had been 27.1 percent in 1995, as we believe would have been appropriate for that year, the crop insurance companies would have received an average reimbursement payment per policy—\$516—an amount that is still more than double the dollar value of delivery expenses for this private passenger automobile insurance. A comparison of the reimbursement for multiple-peril crop insurance on a dollars-per-policy basis to other insurance lines yields similar results.

8. We have carefully reviewed the industry's comments on our report and our methodology, findings, conclusions, and recommendations. We are confident that our work was performed with due professional care using a sound methodology and that our findings are well supported, our conclusions flow logically from the facts, and our recommendations offer reasonable suggestions for reducing the costs of the crop insurance program. Accordingly, we have published this report to make it available for timely decisionmaking by FCIC and the Congress.

9. Regarding the industry's assertion concerning premium rates, as we noted in Crop Insurance: Additional Actions Could Further Improve the Program's Financial Condition (GAO/RCED-95-269, Sept. 28, 1995), FCIC increased premium rates annually from 1991 through 1995. As noted in our current report, FCIC also increased premium rates 3.6 percent from 1995 to 1996. Because of the congressionally mandated goal of a 1.075 loss ratio for the program, it is likely that premium rates will remain at their current level or increase slightly. Accordingly, we continue to hold the view that the assumptions we made with regard to premium levels are reasonable.

10. Data available from earlier years were not in an appropriate format for analysis. In 1989, the companies were required to submit summary expense data and ratios, but according to FCIC, many companies did not submit these data, and the data that were provided were not consistent between companies. Furthermore, in 1991, FCIC rescinded this requirement. In the 1995 standard reinsurance agreement, FCIC began to require companies to submit a detailed expense report in the NAIC format using NAIC guidelines for the prior calendar year—calendar year 1993. However, not all companies complied with the requirement until 1994.

11. Over the last 15 years, the purchase of crop insurance has become more important to farmers. The 1994 reform act restricted disaster assistance payments, and the 1996 farm bill made farmers more responsible for managing risk. As a result, farmers are more likely to purchase crop insurance. Therefore, while agents have to sell the product, farmers now have more incentives to purchase it.

12. We recognize that private companies do not get fully reimbursed for their administrative expenses until the end of the insurance cycle. However, as the companies complete different administrative tasks, such as reporting to FCIC the type of crop and amount of acreage a policyholder has planted, they are reimbursed for their effort. Moreover, we believe that

this arrangement ensures proper internal controls in the program by withholding payments until the work is complete.

13. In examining the 1995 expenses during the course of our review, we found instances of temporary employees being hired as well as overtime being paid. Quite naturally, as business grows, staffing may increase. However, the increases in the number of policies that led to the increase in workload also resulted in increased premium revenues and thus increased reimbursement for administrative expenses.

14. We agree that commercial reinsurance is an important tool for increasing companies' financial capacity and managing their underwriting risk and that reinsurance costs can be legitimate business expenses. However, the cost of reinsurance relates to companies' decisions to manage risk rather than to the sale and service of crop insurance. Therefore, we believe, and FCIC agrees, that this expense should be paid from companies' underwriting revenues and not be considered in determining a future reimbursement rate for administrative expenses.

15. We recognize that acquisition expenses are a legitimate cost of doing business. To the extent that acquisitions could be attributed to physical assets related to the sale and service of crop insurance, we considered them as a reasonable crop insurance expense. However, we do not believe that all acquisition expenses, such as the \$3 million non-compete payment one company reported paying the acquired companies' executives, should be included in the calculation for determining a long-term expense reimbursement rate. FCIC agreed that this is not an expense reasonably associated with the sale and service of crop insurance.

16. Contrary to the industry's assertion, we recognized management fees as a reasonable program expense to the extent that companies could identify tangible benefits received from parent companies. Management fees paid without tangible benefits, however, represent a method of sharing income with the parent company, not an administrative expense reasonably associated with the sale and service of crop insurance.

17. We recognized all bonuses related to employee performance as well as all bonuses paid to agents as reasonable expenses associated with the sale and service of crop insurance. However, we continue to believe that bonuses associated with company profit sharing should not be included in determining an appropriate future reimbursement rate for administrative expenses. For example, at one privately-held company, profits from the

sales of crop insurance—taken after all delivery expenses were met—were paid to executives and employees in the form of bonuses. For the 2-year period, 1994 and 1995, the company paid its executives and employees \$9 million in profit-sharing bonuses, representing about 49 percent of basic salaries in 1994 and 63 percent in 1995. When these profit-sharing bonuses were added to salaries, overall employee salaries at this company were 35-percent higher than the nine-company average.

18. We did not recommend reducing the expense reimbursement rate on the basis of companies' use of corporate aircraft. However, on the basis of our review of the companies' expense documentation, we believe that these and other similar expenses provide opportunities for FCIC to lower its future reimbursement rate for administrative expenses while still adequately reimbursing companies for the reasonable expenses of selling and servicing crop insurance policies. These other expenses included excessive automobile charges; entertainment expenses, including country club memberships and stadium sky box rentals; trips to resort locations; and personal expenses, such as child care and pet care. It is not reasonable to expect taxpayers to fund these types of expenses.

19. We presented a status report on FCIC's simplification efforts in appendix I and did not evaluate the cost savings to the industry that might result. Our report did not use potential reductions in administrative requirements as the basis for concluding that FCIC could lower its reimbursement rate. Any cost reductions resulting from simplification would only serve to further reduce the companies' expenses of selling and servicing crop insurance.

20. Regardless of the terms used, FCIC's reimbursement to companies for administrative expenses is intended to compensate them for the reasonable expenses associated with selling and servicing crop insurance.

21. We stated in our report that the companies have no obligation to spend their FCIC reimbursement for administrative expenses on crop insurance-related expenses because we wanted to point out that companies had no legal requirement to refund federal money spent for activities that are not reasonably associated with the sale and service of government crop insurance.

22. The industry's assertion that the government's cost to use the Farm Service Agency (FSA) to sell catastrophic insurance is 60-percent higher than using the private sector does not reflect the total cost to the

government. The industry excludes (1) the \$50 farmer-paid processing fee, which FSA remits to the Treasury and which the companies generally retain; and (2) the companies' underwriting gains. As noted in chapter 3, these two factors resulted in a total cost to the government in 1995 for companies' delivery that was significantly higher than FSA's delivery cost.

23. We recognize that the private insurance companies perform an important service in informing farmers about risk management. We considered the expenses associated with this effort in determining an appropriate future reimbursement rate for administrative expenses. Therefore, we do not believe that the adjustments in the reimbursement rate that we recommended would reduce the industry's incentives to educate farmers about their risk management needs.

24. The industry's comment reflects some misunderstanding of our (1) accounting for the cost to the government for catastrophic insurance delivery and (2) analysis of the companies' compensation for delivering this insurance. Regarding the government's cost, the \$50 processing fee farmers pay offsets to some extent the government's delivery costs through FSA because this fee is returned to the Treasury. In contrast, the \$50 fee paid to the companies generally has no impact on the cost to the government because the companies retain the fee as income. In analyzing the companies' compensation for delivering catastrophic insurance, we included the \$50 fee in their total compensation for catastrophic insurance because they retain it.

25. While the private sector and FSA have played an important role in implementing the new program, several factors influenced participation in the crop insurance program in 1995 and 1996, including congressionally mandated participation and requirements that disaster assistance be on budget.

26. FCIC pays the companies a percentage of premiums—explicitly for loss-adjusting expenses—that can be used to offset any expenses, including administrative and operating expenses. In fact, the companies' loss-adjusting expenses in 1995 were about 2 percent of catastrophic premiums, while their direct reimbursement from FCIC was about 14 percent of premiums. Additionally, in exchange for delivering catastrophic insurance, private companies receive and retain a \$50 processing fee from farmers, up to a maximum of \$100 per farmer per county.

27. The 1989 Arthur Andersen study of crop insurance delivery expenses may not be an appropriate basis of comparison because it looked at two different private-sector delivery systems—not FCIC and private-sector delivery—and found that one system was less expensive than the other.

28. It is not clear which studies the industry is referencing. However, since the 1994 reform act increased the program’s size dramatically, the relevance of these pilot studies may be questionable.

29. Our report clearly notes that the reimbursement rate will decline through 1999, as required by the 1994 act.

30. As required by the 1994 act, we examined the advantages and disadvantages of alternative means of reimbursing companies for their administrative expenses and did not recommend one alternative over another. Furthermore, we noted that the insurance companies prefer the current system.

31. We did not imply any criticisms of the current reimbursement system’s service to small farmers. Rather, we discussed the potential effects of the alternatives on service to small farmers. In this context, table 4.1 is intended to show how premiums and reimbursements were distributed in 1995.

32. We do not believe that a cap on the administrative expense reimbursement would substantially destabilize the industry. Assuming a capping alternative that achieves an overall 24-percent reimbursement rate, only the largest 5 percent of policies would be affected.

33. This alternative provides incentives for selling both small and large policies—a minimum payment for small policies and a percentage-of-premium component for larger policies.

34. While we agree that this alternative is likely to increase FCIC’s administrative workload, we discuss it simply to present a widely considered alternative for delivery of government services. Moreover, at least one company within the industry believes that the FAR is an appropriate alternative. In 1993, this company testified before the Subcommittee on Agriculture, Rural Development, FDA, and Related Agencies, House Committee on Appropriations, that it endorsed the FAR as an appropriate reimbursement arrangement.

35. As we noted in chapter 4, this alternative may discourage some larger companies from aggressively delivering crop insurance.

36. We acknowledged in our report that other alternatives exist, and we did not intend to provide an all-inclusive analysis of the alternatives available. Instead, we focused on the major alternatives identified by discussions with industry and agency officials.

37. We disagree. We are recommending that FCIC implement an administrative reimbursement rate that pays companies for the expenses reasonably associated with selling and servicing crop insurance.

38. We agree that the program has been generally successful. Furthermore, as we note in the introduction to the report, the private insurance companies are important players in the delivery of federal crop insurance. Nevertheless, the continuing emphasis on reducing the federal budget requires FCIC to ensure that it is not paying more than is necessary to implement the crop insurance program. A lower reimbursement rate—in the range of 24 percent—will adequately compensate companies' for their expenses to deliver crop insurance, and a lower reimbursement rate should not diminish service to the farmer.

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