

RESPONSE OF
NATIONAL CROP INSURANCE SERVICES, INC.
TO THE
REPORT TO THE SECRETARY ON FEDERAL
CROP INSURANCE REFORM
BY THE
U.S. DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL

April 12, 1999



April 12, 1999

Honorable Dan Glickman
Secretary of Agriculture
USDA, Jamie Whitten Bldg., Room 200-A
14th & Independence Ave. SW
Washington, DC 20250

Dear Secretary Glickman:

On behalf of its membership, National Crop Insurance Services, Inc. has prepared and is delivering to you its response to the March 15, 1999 Office of Inspector General Report to you on Federal Crop Insurance Reform. We want to cover three points in this transmittal letter.

First, it is our experience that OIG performs investigations and issues reports when requested to do so. Thus, we want to know (1) who requested, commissioned, or otherwise invited OIG to prepare the subject report and (2) the purpose for which it was requested.

Second, we believe that OIG has exceeded both its statutory authority and its professional competence by raising the public policy issues discussed in the report's Issues 1 and 2. Its resulting mistakes unfortunately color the credibility of the entire report, including its well made points.

Third, our response has a Table of Contents to facilitate your use of it. The section entitled "Executive Summary and Introductory Matters" (pages 1-7) provides a quick overview of our position, especially our challenges to OIG's discussion of private sector revenue and program costs (OIG Issues 1 and 6).

We appreciate your thoughtful attention to our enclosed response. We also express our continuing desire to work with you and your department on the issues involved in crop insurance reform.

Sincerely,

Robert W. Parkerson
President

cc: Roger C. Viadero
Inspector General

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Executive Summary and Introductory Matters

National Crop Insurance Services, Inc. (“NCIS”), a trade association of crop insurers, submits this initial response, on behalf of its membership, to the March 15, 1999 Report to the Secretary on Federal Crop Insurance Reform (“OIG Report”) prepared by the Office of Inspector General (“OIG”) of the United States Department of Agriculture (“USDA”).

The OIG Report: Major Misses, Minor Hits

The OIG Report does not present a balanced, objective discussion of the key economic issues which it raises. Its failings have three elements – easily avoidable factual mistakes, poor public policy analysis, and logical deficiencies. Despite its failings, the OIG Report does provide some useful insights regarding administration of the federal crop insurance program by the Risk Management Agency (“RMA”).

In general, the OIG Report can be characterized as follows:

- When it discusses the economics of the federal crop insurance program, the OIG Report is intellectually dishonest, methodologically unsound, and factually flawed (OIG Issues 1 and 6).
- When OIG's focus is within its area of expertise, it offers some sound analysis (OIG Issues 2 and 4).
- At other times, the OIG Report correctly identifies a problem, but then misapprehends its cause or significance and, therefore, provides a misdirected recommendation for action (OIG Issues 3, 5, and 7 - 8).

In short, the OIG Report has some utility for internal improvements by RMA and reinsured companies, but its efforts to formulate broader public policy decisions are erroneous and, worse yet, grossly misleading.

OIG's intellectual dishonesty is most prevalent in its unsound analysis of the underwriting risks borne by private sector reinsured companies. It never hesitates to label as "minimal" their risks under the current Standard Reinsurance Agreement ("SRA") negotiated in 1997 and effective with the 1998 reinsurance year (July 1, 1997, through June 30, 1998). OIG ignores all persuasive contrary evidence, including congressional testimony of USDA's Deputy Chief Economist on March 10, 1999, that reinsured companies are "exposed to large potential losses." For instance, if the risk-sharing formulas established in the current SRA had been effective during the 1988 drought, the private sector's net underwriting losses would have exceeded \$450 million.¹ That level of loss is not "minimal" – under any understanding of the term. NCIS explores this issue further at pages 16-20, infra.

OIG's avoidable factual errors are noted at pages 3-6, infra. These errors are so serious and obvious that they reveal OIG's total lack of objectivity about private delivery of crop insurance. In the end, the OIG Report must be viewed as nothing other than a facade attempting to mask either blatant bias or institutional incompetence. While OIG certainly excels at writing pithy, attention-getting topic headings, it fails to deliver evidence objectively establishing its main themes.

NCIS Response

NCIS is a trade association of crop insurers. Its members include companies who write hail insurance, with respect to which there is no involvement by the federal government, and

¹ The referenced testimony was provided by Joseph W. Glauber, USDA's Deputy Chief Economist, on March 10, 1999, before the Committee on Agriculture, Nutrition and Forestry of the United States Senate.

who write various forms of catastrophic risk protection insurance (“CAT”) and multi-peril crop insurance (“MPCI”), which the federal government partially supports. NCIS is the statistical agent designated by the insurance commissioners for all fifty states to report loss costs and other data.² Its contacts with RMA mirror its contacts with state insurance commissioners, except that it is involved in the periodic efforts by RMA and the private sector to negotiate the terms of the SRA utilized by the Federal Crop Insurance Corporation (“FCIC”) to provide premium subsidy, administrative and operating expense subsidy, and reinsurance for CAT and MPCI products. So positioned, NCIS is able to offer a comprehensive response to the OIG Report.

NCIS carefully has chosen the word “response” to describe this submission. Use of that term is intended to convey broadly that OIG has made both appropriate and inappropriate findings and recommendations. NCIS offers, therefore, a mixture of criticism and agreement.

NCIS’ overall response will consist of two parts. Drawing on its internal resources and knowledge, it offers its first phase response today. Its second phase response will be provided by April 30, 1999, and will consist of reports authored by PricewaterhouseCoopers LLP and PHB Hagler Bailly, Inc. (the successor to Putnam, Hayes & Bartlett, Inc.).

OIG’s Avoidable Factual Errors

NCIS must set the record straight on six key facts misrepresented by OIG which undermine the credibility of its economic analysis.

First, in criticizing the risk-sharing borne by the private sector, OIG urges RMA to renegotiate the underwriting risk allocation between FCIC and reinsured companies. OIG

² NCIS' purposes include, but are not limited to, the accumulation, tabulation, and analysis of crop insurance statistics; providing insurance information and advice; devising and producing methods and formulas for the determination of the cost of insurance; the furnishing of crop insurance statistics, loss expense ratios, actuarial formulas, rules, forms, and information to its members; consulting with federal and state governmental entities; examining, devising, and publicizing procedures and forms for the adjustment of crop insurance losses; and conducting research and education activities relating to crop insurance.

Report at 14. OIG apparently does not realize the budgetary significance of changes made by Congress in 1998 in the statutory authority of RMA to make changes in the SRA. If OIG is arguing that Congress made a bad public policy decision in sanctioning the current allocation, it fails to recognize that modification of the current allocation could significantly impact budget reconciliation, thus requiring USDA to find offsets. Alternative offsets were not readily identifiable in 1998 when this legislation was enacted and remains the case today. These points are made clear by the Agricultural Research, Extension, and Reform Act of 1998, Pub. L. No. 105-492 (“Research Act”), especially Section 536(b)(2)(A), which establishes the risk-sharing to be borne by the private sector.

Second, OIG claims that reinsured companies receive undue compensation for writing CAT policies because, in part, they retain the administrative fees paid by producers and receive excess loss adjustment payments. OIG Report at 27-29. This is not true as a matter of either fact or law. The Research Act specifies in Section 532(a) that all CAT administrative fees now are to be paid to the FCIC’s insurance fund. Further, Section 532(d) establishes and limits the appropriate loss adjustment expense payable to reinsured companies with respect to CAT policies. Therefore, one can only conclude that OIG is reading the SRA as negotiated in 1997 without recognizing (a) that the agreement entered into by reinsured companies and RMA was subject to funding being made available by Congress (see Section V.N. of the 1998 SRA making all payment obligations of FCIC contingent upon the availability of appropriations) and (b) that Congress subsequently addressed this issue in the Research Act. These erroneous assumptions relate directly to the credibility of OIG’s recommendation.

Third, OIG erroneously asserts that the federal costs of the CAT program for 1998 “were estimated to be about \$443 million.” OIG Report at 9. This is a gross error. The federal cost of

the CAT program actually was \$266 million (the sum of indemnities paid, \$106 million, plus delivery expenses, 14% of imputed premium or \$50 million, plus underwriting gains, estimated at \$110 million). In short, OIG overstates the cost to the government by \$177 million, a vivid example of OIG's biased analysis. The administrative fees paid by producers, moreover, are not a federal cost, since the fees are paid by the producers. In addition, as noted above, OIG fails to mention that since July 1, 1998, these fees have been paid to the government rather than the reinsured companies. Nor does it mention that CAT loss adjustment expenses have been reduced from 14% of imputed premium to 11% (a reduction of 21%).

Fourth, the OIG Report also claims on page 9 that the total crop insurance program cost was \$2.1 billion for 1998. This misrepresents the cost of the program. The 1998 crop year expenses are the sum of the indemnities paid (\$1.6 billion) plus delivery payments (\$427) minus producer paid premiums net of underwriting gains (\$810 million) plus RMA administrative expenses (\$64 million) for a total of approximately \$1.3 billion. OIG apparently does not realize that the federal budget is calculated on a cash basis, and premium subsidies are a bookkeeping matter that do not result in cash payments.

Next, the text of the OIG Report demonstrates the specious analysis in its Figure 1. OIG acknowledges at page 4: "we feel that 5 years does [*sic*] not provide adequate history for actuarial purposes." It is unfortunate that OIG does not follow its own standards when it presents Figure 1 on page 10. It makes a comparison between "Company Revenue" and "Producer Indemnities" over a four year time span that represents the lowest four consecutive years of losses ever experienced in this program. The loss ratios from 1995 through 1998 are 1.02, .81, .51, and .86, respectively. As a result of OIG's use of an unduly short time period, the

underwriting gains are not representative of those historically experienced. In other words, Figure 1 flunks OIG's own test for actuarial analysis.

A final example of OIG's erroneous factual statements concerns its claim that the Farm Services Agency ("FSA") administrative expenses for almost 15,000 employees located in 2,500 field office in 1998 were \$721 million. OIG Report at 13. The 1998 FSA administrative expenses, in fact, approximated \$1 billion. The appropriated amount in 1998 to the FSA administrative account was \$701 million; however, FSA also received \$294 million in transfers from other accounts (for example the Agricultural Credit Insurance Fund, which transfers over \$200 million annually for salaries and expenses to the FSA account). The \$1 billion salaries and expense figure should be compared to the \$427 million paid in 1998 for delivering the crop insurance program. Including underwriting gains in the comparison, moreover, is not accurate since the FSA would bear no risk of paying underwriting losses.³

Errors as fundamental as the foregoing might cause some observers to belittle the entirety of OIG's effort. Although these errors demonstrate OIG's lack of competence on public policy issues and on economic matters, they do not justify casting aside the entire OIG Report.

OIG's Lack of Requisite Professional Experience

OIG simply lacks the professional experience necessary to offer economic and public policy recommendations. That is evident in two respects.

³ NCIS acknowledges the assistance provided by the American Association of Crop Insurers in identifying OIG's egregious errors in discussing federal budgetary matters.

First, the OIG Report raises fundamental public policy and economic issues. That is not the mission of USDA's OIG. NCIS' principal point of reference is the Inspector General Act of 1978, as amended, 5 U.S.C. App. 3. An Inspector General serves many important functions, but none of them is to speak to fundamental matters of public policy. The OIG Report wanders far from presenting audit or investigation results that relate to program economy, efficiency, or effectiveness, which detect fraud or abuse, or which identify administrative deficiencies. Public policy and economic expertise are not even among the qualifications of an Inspector General. Plainly stated, OIG simply lacks the institutional experience required to recommend changes in public policy, such as returning delivery of crop insurance exclusively to USDA.

Second, OIG draws unsupported, unsupportable, and illogical conclusions when discussing Issues 1 and 6 (private sector profitability and CAT). Senior OIG management now must embarrass itself either by defending or by repudiating the entirely inadequate work in those areas.

The Key Public Policy Issues

The OIG Report raises an overarching public policy question of profound significance: What is the proper role of the federal government in strengthening crop insurance as a risk management tool? In the end, there really are only three conceptual alternatives:

- A program fully operated and funded by the federal government and lacking in market disciplines and incentives;
- A fully private system without any federal funding and lacking the ability to provide affordable insurance to a broad spectrum of agricultural producers; or
- A mixed, or hybrid, approach that introduces a balancing of governmental

and private interests and which entail a sharing of risks between those sectors.

The OIG Report reveals a bias in favor of a purely governmental approach, the first alternative and one which experience demonstrated from the 1930s through 1970s entailed unacceptably low producer participation. Fully privatizing crop insurance, with no governmental financial support whatsoever, might be attractive to the private sector, but premium increases likely would diminish radically producer participation. In 1980, Congress elected a hybrid approach. Hence, the private sector now has undertaken a significant role through executing a series of SRAs with FCIC. The entire thrust of administrative and congressional action since 1980 has been to refine and strengthen this hybrid approach.

Despite raising an issue of fundamental importance, the OIG Report does not contain any substance from which an answer can be developed. This is a critical failing, especially since OIG entirely ignores significant social aspects of the crop insurance program. The fundamental concept is that all eligible producers must be accepted as insureds. In other words, reinsured companies may not decline to write coverages within a state or to accept a producer as an insured. Once a company undertakes to provide any federally reinsured product in a state, it must offer all such products to all applicants. Further, it must do so despite any control over premiums charged. NCIS' members recognize that participation in the federal crop insurance program carries such obligations. OIG fails to recognize, however, the range of financial implications which such obligations bring.

Any decision involving changing the delivery system for crop insurance is significant and entails implications for all aspects of the program. What would be, for example, the effects on

producer participation levels, on loss adjustment practices, and on the overall loss ratio? The OIG Report provides no analysis of such issues. For instance, OIG advocates increasing the private sector's share of underwriting losses, but it never ventures any analysis of the implications of doing so. Before being so cavalier in introducing such a topic, OIG should have paused to consider factors such as the following:

- If reinsured companies are to retain an increased share of the risk, especially the riskiest business that now is placed in the Developmental and Assigned Risk Funds, what will be the impact on premiums charged producers?
- If RMA refuses to increase premiums and leaves coverage unchanged, what happens to the program's actuarial integrity?
- If premiums are not to rise, what happens to coverage? Will it be reduced to maintain an acceptable loss ratio?
- If premiums rise to compensate reinsured companies for retaining increased risk, what happens to producer participation?
- If reinsured companies are to retain an increased share of the risk, they will be entitled to claim an increased share of underwriting gain, which currently is shared between the private sector and the Treasury. What is the budgetary impact of reducing the government's income in years (such as 1996-98) when there were shared underwriting gains?

OIG's failure to identify, let alone address, such questions reveals its lack of competence on public policy issues such as the ones raised in the OIG Report.

OIG also forgets that Congress has debated these program delivery and cost issues for decades. Yet, OIG reveals no understanding of the balancing of interests which Congress performed and of the underlying policy judgments.

Finally, OIG suggests that Congress, despite decades of debate, should reverse its prior decisions (starting with 1980 and running through last year). OIG, however, provides no supporting evidence or analysis.

OIG does not possess the public policy expertise to provide credible advocacy for the diametrically opposite alternatives of a purely governmental or a fully privatized system of crop insurance. To the extent that OIG has pertinent and useful expertise, it relates to offering findings and recommendations focused on the extent to which government and the private sector are performing adequately under the duties assigned to them by Congress and refined through FCIC regulations, contracting practices, and oversight. It is understandable, therefore, that OIG has failed to make any meaningful contribution on the key economic issues. It also is the product of OIG's erroneous assumptions, poor methodology, and factual misstatements. On the other hand, when OIG focuses on administrative issues, it makes some appropriate points, but misapprehends others.

The Crop Insurance Program

Until 1980, federal crop insurance only was available through USDA. Passage of the Federal Crop Insurance Act of 1980 (the "Act") provided the statutory foundation for the present system. Initially, starting in 1981, FCIC began executing a series of SRAs by which it offered reinsurance to the private sector. In essence, the initial phase of the present system involved dual

delivery under the federal program. On the one hand, FCIC directly wrote insurance policies; in those circumstances, the government incurred all of the administrative and operating costs and retained all of the underwriting gain and loss. On the other hand, the private sector sold insurance policies reinsured by FCIC; in those circumstances, the government subsidized a portion of the premium paid by producers, principally paying the portion attributed to administrative and operating expenses (“A&O subsidy”), and reinsured a portion of the underwriting risk in return for a portion of underwriting gain.

The purpose of introducing private sector participation was to increase the participation rate of agricultural producers. Congress set a goal in 1980 of increasing the participation rate to 50%, but it had not been met by 1993. However, private sector participation had more than tripled the participation rate, taking it from 10% under the purely governmental program to 32% in the hybrid program.

The next generation of developments in the federal crop insurance program came with passage of the Federal Crop Insurance Reform Act of 1994 (the “Reform Act”). When the Reform Act was passed, the expectation was that participation could be increased to 80%, not just the old goal of 50%. The basis for this expectation was that the private sector would market aggressively crop insurance products. Despite setting an aggressive goal, the private sector succeeded, increasing the participation rate to 88% subsequent to passage of the Reform Act. Although participation rates have fallen somewhat in the most recent years, voluntary participation remains at the 65% level.

The next major stage in the development of the marketing of the federal crop insurance program came with passage of the Federal Agriculture Improvement and Reform Act of 1996 (the “FAIR Act”). Pursuant to the FAIR Act, the Secretary was directed to determine the private

sector capacity to deliver CAT insurance and to transfer all CAT policies from FSA to the private sector. Following the passage of the FAIR Act, Secretary Glickman made the requisite findings in two stages and caused FSA's only remaining insurance functions to be transferred to the private sector. This brought the delivery of federal crop insurance programs to a polar opposite position when contrasted with the period prior to 1980 when it was exclusively a governmental program. The FAIR Act also removed management of the FCIC from the administrative functions assigned to FSA, created RMA as a separate agency within USDA, and placed management of FCIC with RMA.

As noted above, Congress' dominant purpose for introducing first partial and then exclusive private sector delivery of crop insurance was to make participation in the federal crop insurance program as widespread as possible among agricultural producers. In itself, this was a salutary and important goal. Beyond simply achieving the objective of increasing producer participation, however, other important governmental interests were intended to be met.

First, low participation introduces a concern about unacceptable loss ratios. The theory, as well as the reality, of broadening participation was that increasing the number of participants would lower the aggregate risk on a nationwide basis, thereby ultimately permitting a reduction in the loss ratio. The theory is sound. Basically, the working hypothesis was (and remains) that in a country as large as the United States, with extremely diverse agricultural production, serious losses in one region or with respect to several crops can be offset by underwriting gains in other regions.

Second, coupled with broadening participation would come introduction of new coverages. The private sector, driven by profit incentives, would bring new ideas, a nationwide delivery system, broad experience in risk management methodology outside of agriculture, and

broader resources to develop new crop insurance products more attuned to the risk management needs of America's producers, thus expanding the number of crops covered.

Third, Congress hoped to eliminate what had become the annual politically inspired and undisciplined off-budget appropriations of ad hoc disaster assistance. Appropriations for such purposes were annually averaging \$436 million between 1974 and 1980. Until the private sector became involved and achieved widespread success in marketing crop insurance, Congress still appropriated, and USDA dispensed, substantial disaster assistance related to crop losses, even after passage of the Act, distributing \$5.6 billion over the 1981 to 1988 period. By 1989, these annual ad hoc disaster payments had reached in excess of \$4.0 billion with another \$3.25 billion and \$3.1 billion for 1993 and 1994, respectively. These annual disbursements of payments, without the discipline of actuarial soundness and without regard to standards of fairness from one disaster to the next, created an atmosphere of competition between crop insurance and the ad hoc disaster payments, with crop insurance at an unfair disadvantage. Following the passage of the Reform Act in 1994, which created budget hurdles for passage of ad hoc disaster relief, crop insurance participation expanded and has remained substantially above the pre-Reform Act level.

When focusing on the public policy issues of federal crop insurance reform, it is important to note that these fundamental congressional objectives have been met. Producer participation has been taken from the 10% level under FCIC to a 65% level at the present time. Loss ratios, despite serious disasters on a broad scale in 1988 and 1993 and of a regionally severe nature in 1997 and 1998, have been reduced. Program innovation and diversity have expanded dramatically. Although the objective of entirely eliminating ad hoc disaster assistance has not been achieved, it is possible to conclude that disaster appropriations would have had to have

been even larger if program participation had remained at the unacceptably low level prior to introduction of the private sector as a partner in delivery of crop insurance.

A major deficiency of the OIG Report, in view of the foregoing, is its failure to analyze whether congressional objectives could have been met absent private sector involvement. NCIS only can offer the historical record as commentary. With nearly fifty years of exclusive USDA control of product innovation and delivery, the federal crop insurance program experienced unacceptably low producer participation. Fortunately, for the benefit of American agricultural producers and the Treasury of the United States, private sector participation has reversed that poor USDA record.

Issue 1 – Company Revenue

OIG has not contributed in any objective fashion to an understanding of the economic functioning of the federal crop insurance program. OIG's analysis of FCIC's payments to reinsured companies, moreover, does not prove its proposition that there is inequitable risk sharing costing the government millions of dollars. Further, OIG has a little disguised bias in favor of substantially more pervasive federal control of, if not outright replacement of, the private sector in the delivery of crop insurance. Although the constituency of NCIS plainly reflects the interests of the private sector, NCIS itself is not offering any proposals for crop insurance reform. Instead, NCIS believes that its most useful contribution is to act as an honest broker of information in its role of providing education about crop insurance, which is one of its principal functions.

In responding to OIG's Issue 1, NCIS draws on the terms of the current SRA, its knowledge of the federal crop insurance program, and two reports which it received in 1997

from independent consulting firms, Price Waterhouse LLP⁴ and Putnam, Hayes & Bartlett, Inc.,⁵ analyzing a spring 1997 report by the General Accounting Office (“GAO”) entitled “Crop Insurance Opportunities Exist To Reduce Government Cost For Private Sector Delivery” (GAO Report No. GAO/RECED-97-70) (“GAO Report”). NCIS now undertakes to establish OIG’s intellectual dishonesty, methodological errors, and factual mistakes embedded in its analysis of program economics. Private sector revenue most assuredly is not increasing at the expense of program management.

The OIG Report Fails To Provide Any Profitability Analysis.

OIG acts as if it had no knowledge of the distinction between revenue and net income. It lumps together all revenue sources of reinsured companies (underwriting gains and A&O subsidy) for four years and compares the aggregates by year to indemnities paid in that period. OIG fails to deduct from the companies’ revenue stream any program expenses borne by them. As Price Waterhouse found in 1997, the companies’ cumulative expenses over the eight-year period 1988–95 exceeded their total A&O subsidy received from FCIC.⁶ Since then, the A&O subsidy has been reduced. OIG is deliberately misleading users of its report by failing to factor out private sector expenses. Had it done so, it would have found that reinsured companies historically have been dependent on their share of underwriting gains for any net profit.

The fact of the matter is that OIG has not performed a profitability analysis. All it has done is compare revenue to indemnities paid without any consideration of expenses. Then, without even a passing attempt to perform a profitability analysis, OIG proceeds to argue for

⁴ Cited herein as the “PW Report.”

⁵ Cited herein as the “PHB Report.”

⁶ NCIS has asked this firm to update its analysis through the 1998 reinsurance year ending June 30, 1998, so that an eleven-year history is available.

reallocation of underwriting gain (with less going to the private sector) and consideration of returning to a program which is entirely funded and operated by USDA. OIG must think it can insult the intelligence of Secretary Glickman and Congress with such an uninformed approach.

NCIS believes that exposure of fundamental financial data will belie OIG's rhetoric. Thus, it now proceeds to demonstrate the following propositions:

- Reinsured companies bear substantial, not minimal, underwriting risks.
- Reinsured companies are exposed to maximum possible underwriting losses exceeding their maximum potential for gain.
- OIG's methodology is wrong.
- Reinsured companies operate efficiently.
- While profitable, reinsured companies do not profit at an unacceptable level.

In sum, OIG is flat wrong on its Issue 1.

The OIG Report Distorts SRA Risk Sharing Allocations.

A major and recurring premise of the OIG Report is that many ills result from the "minimal risks" retained by the private sector through the SRA for its share of underwriting losses. Analysis of the SRA in effect since July 1, 1997 belies the position of OIG.

As an initial matter, OIG fails to analyze the terms of the current SRA. Fortunately, USDA's Deputy Chief Economist has done so, and he has provided Congress with this conclusion: "While the potential for underwriting gains is large, reinsured companies have also been exposed to large potential losses." See page 2 and note 1, supra. Had the 1998 SRA's risk-

sharing formulas been in place during the 1988 drought, the companies' net underwriting losses "would have exceeded \$450 million." Id. That is significant, not immaterial, risk.

OIG deliberately uses terms like "minimal" and "little" in describing the private sector's share of underwriting risks. This represents an effort to mislead readers of the OIG Report into believing that the federal crop insurance program represents some sort of windfall to reinsured companies because of their nominal exposure. The facts refute this distortion.

OIG's superficial approach completely ignores the detailed risk-sharing formulas set forth in the SRA. Table 1, which follows on the next page, plainly demonstrates that the private sector retains very substantial risk. This is particularly true for the Commercial Fund. NCIS also understands that the private sector has been increasing the amount of coverage designated to the Commercial Fund, especially for the 1998 and 1999 crop years.

OIG has no factual basis for claiming the private sector bears minimal risk. Only for the Assigned Risk Fund does the private sector bear risk at the 20% (or lower) level, but that is immaterial as far as the entire program is concerned. First, the SRA in Section II.B.1. strictly limits the amount of coverage which a reinsured company may designate to the Assigned Risk Fund. Thus, reinsured companies are not able to shift risks to the government without limitation. Second, all pilot program coverages are designated to this fund, thus consuming not immaterial portions of a company's discretion to designate other coverages to it. Third, when Tables 1 and 2 are compared, it becomes obvious that a reinsured company's risk exposure exceeds substantially its gain potential in the Assigned Risk Fund.

Table 1

Each Reinsured Company's Minimum Percentage of Retained Underwriting Losses In Relation To Net Book Premium

	<u>Producer's Loss 0 – 100% of NBP</u>	<u>Producer's Loss 101 – 160% of NBP</u>	<u>Producer's Loss 161 – 220% of NBP</u>	<u>Producer's Loss 221 – 500% of NBP</u>
CF (B)	50.0	50.0	40.0	17.0
CF (C)	50.0	50.0	40.0	17.0
CF (R)	50.0	57.0	43.0	17.0
DF (B)	35.0	25.0	20.0	11.0
DF (C)	35.0	25.0	20.0	11.0
DF (R)	35.0	30.0	22.5	11.0
ARF (B)	20.0	5.0	4.0	2.0
ARF (C)&(R)	20.0	0.0	0.0	0.0

Notes 1. Abbreviations used above represent the following:

- CF – Commercial Fund
- DF – Developmental Fund
- ARF – Assigned Risk Fund
- (C) - CAT
- (R) - Revenue insurance plans
- (B) - All other crop insurance plans

2. A reinsured company may increase its retained share of losses in the Commercial and Developmental Funds in 5% increments for losses equal to or less than 100% and the related share of the premium. See SRA §§ II.B.2.d and II.B.3.b.
3. The SRA limits the aggregate amount of risk which a reinsured company may place in the Assigned Risk Fund. See SRA § II.B.1.d.

Table 1 identifies the reinsured companies' risk exposure under the SRA. They admittedly also have the opportunity to profit by sharing underwriting gains with FCIC. The potential for both loss and gain raises the issue of whether the private sector enjoys too great a share of gain. There are two ways of resolving this issue. First, are the annual formulas balanced? Second, over the long term, has the private sector profited to an excessive extent? The OIG Report answers neither question. It obviously presents insufficient data to answer the second question, and its short term analysis is superficial at best.

The OIG Report also fails to recognize that reinsured companies annually bear a maximum risk allocation generally greater than their maximum potential for gain. Section II.D. of the SRA sets forth a company's right to retain underwriting gain. Table 2 on the next page summarizes the maximum retentions by fund (Commercial, Developmental, and Assigned Risk) and policy (CAT, revenue, and all others) based on state-by-state loss experience. The formulas, of course, stop when the loss ratio reaches 100% of net book premium because then the transaction is in a negative position. Until that point is reached, however, a reinsured company generally has less opportunity for gain than its downside exposure to loss. Neither the private sector nor RMA can be faulted for this risk-gain allocation in a public-private partnership for providing federally subsidized crop insurance to agricultural producers. Also, OIG seems oblivious to the fact that Section 536(b)(2) of Research Act reflects Congress' judgment of the propriety of this allocation.

NCIS offers its separate observation about long term profitability in the concluding portion of its discussion of OIG's Issue 1.

Table 2

Each Reinsured Company's Percentage of Retained Underwriting Gains In Relation To Net Book Premium By Fund and State

	<u>Loss Ratio 0 – 49% of NBP</u>	<u>Loss Ratio 50 – 64% of NBP</u>	<u>Loss Ratio 65 – 99% of NBP</u>
CF (B)	11.0	70.0	50.0
CF (C)	8.0	50.0	50.0
CF (R)	11.0	70.0	57.0
DF (B)	6.0	50.0	25.0
DF (C)	4.0	30.0	25.0
DF (R)	6.0	50.0	30.0
ARF (B)	2.0	9.0	5.0
ARF (C)&(R)	0.0	0.0	0.0

Notes Abbreviations used above represent the following:

- CF – Commercial Fund
- DF – Developmental Fund
- ARF – Assigned Risk Fund
- (C) - CAT
- (R) - Revenue insurance plans
- (B) - All other crop insurance plans

The OIG Report Is Replete With Methodological Errors.

OIG has made several methodological errors of fundamental significance. They pervade its lengthy indictment of private sector revenue from crop insurance and RMA's tolerance of that income stream.

First, OIG draws a substantial number of conclusions and inferences using data confined to the 1994 through 1998 crop years. Such a narrow focus may be appropriate for some purposes, but it is entirely inappropriate when focusing on whether there is a reasonable allocation of risk and gain between the private and public sector partners in the federal crop insurance program. Although the 1997 and 1998 crop years entailed some very serious production losses for a number of agricultural producers, especially in North and South Dakota and Texas, those losses were nowhere near as pervasive or substantial as the production and revenue losses experienced by agricultural producers in 1988 and 1993. In focusing its analysis on a narrow band of years free from pervasive losses of the types encountered in 1988 and 1993, OIG necessarily has skewed the data offered in its report, thereby compromising the integrity of many of its conclusions and inferences. While this methodology or logic may work well for government, if one assumes that the governmental entity has access to "such funds as needed" from the federal Treasury, it does not bode well in a business environment of private insurers and reinsurers who must depend on gains in good years to offset loss exposure in bad years. Selective use of data to draw or support conclusions suggests that the conclusions were made and data selected to support OIG's predetermined position.

OIG's Figures 1 and 2 (pages 10 and 12) offer data for four years. From this limited range of data, OIG then draws broad conclusions about reinsured companies' exposure to risk-sharing and overall profitability. OIG's use of this limited range of data is more than unsound

methodology; it also is hypocritically inconsistent, for OIG elsewhere states “that 5 years does [*sic*] not provide adequate history for actuarial purposes.” OIG Report at 4. That it would turn four years of experience against the private sector, while fully recognizing that such a short period is insignificant for evaluating the loss-gain cycle for crop insurance, evidences pure bias on the part of OIG.

The OIG Report also perpetuates the methodological errors of the GAO Report. Like the GAO, OIG uses too short a period of time to perform an appropriate profitability analysis. Its four-year time is no sounder than GAO’s two-year one. Putnam, Hayes & Bartlett, Inc. accurately dissected the methodological error when it analyzed the GAO Report:

The GAO’s ability to draw conclusions from its analysis is seriously hampered by the fact that its analysis is based entirely upon data drawn from a two-year period characterized by favorable loss experience. The historical record of the crop insurance program provides no basis for believing that relationships observed over such a short period will continue to hold over the entire loss cycle. The bulk of the losses in the program have occurred during infrequent and irregularly spaced years characterized by widespread natural disasters. The last such disaster was the flooding that occurred in 1993, immediately preceding the period of the GAO study. Infrequent large-scale natural disasters of this type have made premium setting difficult. They have also posed major challenges for program design and program administration, causing major changes in loss adjustment workloads and claims processing volumes.

Because of the highly cyclical nature of the crop insurance program, *any* analysis of the crop insurance program based upon a short period of time will present a biased picture, casting the program and its participants in either a favorable or an unfavorable light, depending upon the period chosen. [Footnote omitted.] The program’s performance, and that of the companies that make it up, can only be assessed in the context of the full loss cycle. The GAO Report does not present information that would allow such a full assessment.

PHB Report at 12-13 (emphasis added). Like the GAO, OIG inexplicably begins the time frame for its revenue analysis with the 1995 reinsurance year (July 1, 1994 through June 30, 1995). OIG Report at 10-13. Like the GAO, therefore, OIG has excluded the staggering net underwriting losses sustained in 1993.

The GAO Report was replete with other methodological errors. NCIS already has rebutted that report through able critiques prepared by Price Waterhouse LLP (attached as Appendix A) and Putnam, Hayes & Bartlett, Inc. (attached as Appendix B). While these reports are useful for many purposes, they categorically establish that a short period, such as the five years purportedly studied by OIG, is statistically and actuarially unsound as a basis for drawing profitability considerations. The five years studied by OIG entailed the unprecedented combination of record production and substantially lower than normal loss ratios. The PW Report extended the GAO's analysis to include an eight-year time frame, and the extended analysis convincingly demonstrated that the private sector has experienced substantial losses in its partnership with the federal government in providing CAT and MPCCI coverage.

OIG also fails to recognize that subsequent market events have nullified any utility of the GAO Report on the issue of private sector profitability. It was that report which touted ever-increasing crop prices as a basis for slashing subsidies paid to the private sector for the benefit of producers and reinsurance support. The OIG Report contains sufficient data reflecting the decline in crop prices that OIG itself provides a compelling foundation for rejecting the analytical skills and economic findings of the GAO.

The Private Sector Provides Cost-Efficient Program Administration.

Unfortunately for the credibility of the OIG Report's economic analysis, it draws heavily upon the GAO Report without contributing any new facts, insights, or understanding on the issue of private sector efficiency. Accordingly, it is appropriate to summarize here the independent professional analysis in 1997 of the GAO Report which NCIS received. In its analysis of the GAO Report, Price Waterhouse accumulated financial data from the same nine companies audited by GAO. These nine companies accounted for 85% of total MPCCI premium. Thus, the

conclusions Price Waterhouse drew from that data are supported by very substantial evidence. PW Report at 2.

Price Waterhouse explicitly found that reinsured companies consistently show lower total expense ratios than the property/casualty industry as a whole and that their expense ratios have decreased during the eight-year period studied (1988–1995). *Id.* at 4. Similarly, Putnam, Hayes & Bartlett, Inc. found that, on an inflation adjusted basis, the administrative cost per acre for providing crop insurance through reinsured companies had diminished over a comparable time span. PHB Report at 4–5.

When the GAO proposed a reduction in the “A&O subsidy” from 31%, where it was for the 1997 reinsurance year, to 24%, which it proposed for the 1998 reinsurance year, it contended that this reduction could be achieved from a combination of three factors. As Price Waterhouse calculated, the 23% reduction in A&O Subsidy would be allocated as follows: (1) “the effect of [eliminating] ‘excess’ current reimbursement based on one favorable year’s experience in the last eight years” (5%); (2) disallowing expenses that arise in the ordinary course of business (8%); and (3) the “leveraging effect of higher prices, based on two years of higher crop prices” (10%). PW Report at 5. Needless to say, the GAO’s third factor was totally discredited in 1998 by producers’ receiving the lowest commodity prices paid them in thirty years. This depression of prices is projected to continue into the 1999 crop year and the foreseeable future, yet OIG still apparently is relying on this flawed analysis to draw erroneous conclusions regarding the efficiency of the delivery system notwithstanding the challenges of delivering new products, adding new crops, and the overall risk management education needs.

Expense ratios for reinsured companies consistently are lower than the comparable expense ratios for the property/casualty industry as a whole. Further, MPCCI expense ratios have

diminished over the eight years studied by Price Waterhouse (1988-1995). Id. at 17–19. In fact, over this eight-year period, the nine companies studied received A&O subsidy that, in the aggregate, was less than their expenses incurred. Id. at 32.

The GAO's premise that higher crop prices could yield sufficient reimbursement, with FCIC's paying a lower percentage for A&O subsidy, was absurd. First, the GAO unreasonably used a short time period, consisting of a three-year window, for inferring that crop prices apparently would continue to rise, thereby increasing the premium subsidy paid by FCIC. If one were to take two of the three years utilized by the GAO (1996 and 1997), it could just as easily be demonstrated that crop prices on average had fallen and, with that decline, the reinsured companies' expense reimbursement. Moreover, this sort of faulty analysis ignores the fact that a significant portion of expenses incurred, most notably agents' commissions, vary directly with the level of premiums. PW Report at 45-47. Putnam, Hayes & Bartlett, Inc. also thoroughly discredited the "rising crop price" approach sponsored by GAO. PHB Report at 13-14.

In absolute dollars, administrative costs for the federal crop insurance program have grown. This has been a function of increased participation by producers. The A&O subsidy percentage, however, also has declined substantially. In fact, on an inflation-adjusted per-insured-acre basis, both reinsured company and total program administrative costs have declined since the mid-1980s. PHB Report at 4-5. In addition, despite diminishing subsidy levels, program complexity has increased as RMA has created new administrative burdens on reinsured companies.

The Private Sector Receives No Excessive Profits.

Price Waterhouse drew several important conclusions regarding the relative profitability of reinsured companies writing MPCIC coverage. First, compared to other property/casualty

insurers, MPCPI business is substantially more volatile, thus entailing greater risk than the property/casualty industry as a whole. Second, MPCPI business is more complex than that of other property/casualty lines. This is principally the product of meeting regulatory requirements imposed by FCIC, and these requirements often are politically influenced without regard to changes in risk retained by insurers or reinsurers or without opportunity for the private sector to make changes in their annual “plans of operation” required under the SRA. Further, as a condition of receiving FCIC reinsurance, companies must agree as a matter of public policy to insure all eligible producers. For example, RMA recently removed from the regulation premium adjustments for producers on the “Nonstandard Classification” based on poor loss records over a period of years. This unilateral action added these producers back into the risk pool without corresponding adjustments in the overall premium rates. Third, the aggregate level of profits for MPCPI business is less than the property/casualty industry as a whole. Id. at 3.

It is significant that the OIG Report commends the GAO Report while at the same time raising an issue about excessive gains by reinsured companies. The GAO Report, in this respect, states that the government should set a long-term target for underwriting gains by reinsured companies that “do not routinely exceed” 7% of the premium revenue for which they retain risk. GAO Report at 51. Whether or not one agrees with this opinion of the GAO, it is significant that, utilizing the formulation proposed by GAO, reinsured companies’ average gain on earned premium for the years 1988 through 1995 averaged 7.5%, obviously within the range treated as acceptable by the GAO. PW Report at 4. Moreover, GAO recognizes that in some years gains will exceed the targeted level. The point it makes is that, over time, net gains should center around 7%, which they certainly did for the period 1988 – 95.

GAO is dead wrong, however, in advocating limiting net underwriting gain on retained premium to the 7% level. That begs entirely the issue of whether that level of gain translates into a sufficiently attractive return on capital (generally called “surplus” in the insurance industry). In point of fact, a 7% gain on retained premium translates into a 4.83% return on surplus.⁷ Yet, that return on surplus is unattractive since a reinsured company could achieve a risk free return of 5 to 5.5% by investing its surplus in Treasury bonds, or it could redeploy its surplus to less volatile property/casualty lines and earn 14.1% on its surplus. This analysis yields two points. First, measured by the GAO’s test of reasonable profitability, reinsured companies clearly do not enjoy any excess profitability. Second, that level of profitability is itself unattractive.

Three key points need to be made about the overall profitability of the MPCCI line of business. First, the pre-tax rate of return on this line of business was 11.7% over the eight-year period studied by Price Waterhouse, and that is significantly lower than the 14.1% earned by the property/casualty industry as a whole. Second, the volatility of the MPCCI line of business is almost 50% greater than the aggregate experience of the property/casualty industry as a whole. Third, as already noted, reinsured companies’ return on the portion of premiums for which they retain risk averaged 7.5% for the eight years studied, which most certainly within the range believed appropriate by the GAO. *Id.* at 6 and also 14–15.

As Putnam, Hayes & Bartlett, Inc. found, “the available evidence fails to support the GAO’s assertion that the private participants in the program are being overpaid.” PHB Report at 7. If the allegation of the GAO were true, a substantial number of new firms should be entering the market and executing SRAs with FCIC. That is the natural free market response. Program

⁷ This can be calculated using RMA’s requirement that reinsured companies maintain surplus equal to approximately 130% of premium.

demographics certainly do not demonstrate any such response, however, as the number of SRA holders has declined from approximately fifty in 1985 to seventeen today.

Issue 2 – Conflicts of Interest

Vigilance over conflicts of interest issues always is appropriate. NCIS reads the OIG Report to recommend heightened scrutiny by reinsured companies of their employees and contractors. This is appropriate. The Act, FCIC’s regulations thereunder, and the SRA already establish adequate practices, procedures, and limitations. The issue, therefore, is increasing the private sector’s level of success in implementing those practices, procedures, and limitations.

Issue 3 – Loss Adjustment Errors

Loss adjustment errors are atypical with respect to program crops. They also are atypical with respect to specialty crops, but OIG usefully recognizes that the higher values associated with such crops (citing raisins and nurseries) can magnify the economic significance of errors.

Improving the overall quality of loss adjustment must start with RMA. It must develop adequate and understandable policy provisions, insuring documents, and loss adjustment procedures in the first instance, and then it must apply them consistently when working with reinsured companies. RMA, therefore, must be receptive to positive feedback from reinsured companies and agents regarding inconsistent interpretations of rules and procedures by its regional service offices (“RSOs”) and Compliance Division (“Compliance”). Failure by reinsured companies to follow rules and procedures, although there may be significant differences in interpretation between RSOs and Compliance, can subject reinsured companies to substantial penalties or sanctions, including denial of FCIC reinsurance. Material improvement by RMA in these areas would assist the reinsured companies with their quality control efforts.

NCIS disagrees with a major premise of OIG in discussing the loss adjustment process. OIG erroneously argues that “reinsured companies have no incentive to protect the Government’s interests” when adjusting losses. OIG Report at 17. OIG constructs this argument from its fallacious view that reinsured companies only bear minimal risks. In fact, since reinsured companies have substantial loss exposure, as developed under NCIS’ discussion of Issue 1, they have more than adequate incentives to adjust losses properly.

The loss adjustment issue raised by OIG only has merit to the extent that it flags a quality control issue; it certainly is not a systemic problem.

Issue 4 – Proper Research and Development

OIG makes its greatest contribution by documenting the bases for its recommendation that RMA must take greater care in developing and approving new policies or expansion of existing coverages. This also is a matter of paramount concern because the Act mandates that crop insurance programs offered or reinsured by the FCIC are to be actuarially sound. 7 U.S.C. §§ 1506(o) and 1508(i). This is a matter of fundamental importance to reinsured companies. Quite bluntly, whenever RMA makes an actuarial or other coverage error, it costs reinsured companies under the risk-sharing formulas in the SRA. See Table 1. As a trade association of insurers, NCIS is well versed in the moral hazard and adverse selection risks which can result from poorly-developed insurance policies. Unfortunately, RMA continues to introduce policies and changes to policies which generate these risks.

NCIS can add to OIG’s discussion by relating its experience with two imprudent decisions made by RMA: its recent institution of both new and expanded coverage for nursery crops and its expansion of prevented planting coverage for 1996 spring planted crops. Before

doing so, NCIS submits that OIG's and its own criticism must recognize two key points about product innovation.

First, all innovation involves risk, and even the most thorough research cannot anticipate all risks, especially those associated with weather and commodities markets. In other words, all interested parties must recognize that years of actual experience are necessary to refine new coverages and their pricing.

Second, product development in the crop insurance industry entails a great deal of risk because newly insured crops do not bring with them the years of historical loss data that would be available, for example, for a crop like corn. Because the program seeks universal coverage, RMA must strive to develop coverages for all crops. That program reality increases the likelihood of errors. As RMA develops coverages for more and more specialty crops, therefore, the problem inevitably will continue, thereby necessitating great care in structuring policies for such crops.

1998 Nursery Rule

RMA created several adverse selection and moral hazard risks when it expanded nursery crop coverage on September 24, 1998, when FCIC published in the Federal Register as a final rule its Nursery Crop Insurance Regulations, Common Crop Insurance Regulations and Nursery Crop Insurance Provisions ("1998 Nursery Rule") declared it effective immediately. 63 Fed. Reg. 50965, 50975 (Sept. 24, 1998). This coverage concerned a policy year starting seven days later on October 1, 1998.

The SRA contemplates that insurance policies issued by NCIS' members are continuous. To protect the interests of both insurance companies and policyholders, the SRA requires that each policy must have a contract change date and a cancellation date. The contract change date

is the date “by which FCIC must publish all changes to the crop insurance contract in order to make such changes binding on” the companies and policyholders. SRA § I. The cancellation date is “the date by which the Company or policyholders must notify the other that coverage” is to be terminated for the succeeding crop year. Id. These dates generally differ substantially so that both companies and policyholders may assess in an informed fashion their options. As applied to nursery crops for the current 1999 reinsurance year, the contract change date was June 30, 1998, and the cancellation date was September 30, 1998, thereby providing a three-month period in which contract changes could be communicated to producers of nursery crops, evaluated by them, and considered as part of the ultimate decision to renew or to cancel coverage. For new policyholders, the sales closing date was the same as the cancellation date for existing policyholders. Thus, under the SRA, the prospective purchasers of MPCCI or CAT coverage for nursery products in the 1999 reinsurance year were required to submit their applications by September 30, 1998.

RMA caused FCIC to declare the 1998 Nursery Rule effective immediately despite the following factors, among others, warranting delay: (i) the imminence of the cancellation and sales closing date (six days away on September 30, 1998); (ii) the unavailability of actuarial data and loss adjustment procedures necessary to implement the new program; (iii) the inability of FCIC to identify at the effective date the rating structures to be used nationwide; and (iv) the existence of a number of material unresolved issues at the effective date (such as unspecified management practices needed to care for balled and burlapped plant material or to obtain a waiver of irrigation requirements).

The 1998 Nursery Rule also authorized for the policy year the sale to producers of both the Nursery Crop Insurance Provisions contained in the 1998 Nursery Rule and prior Nursery Crop Provisions:

FCIC has elected to allow nursery producers the option of insuring their nursery crop under the existing Nursery Crop Insurance Provisions or these new Nursery Crop Insurance Provisions. As a result, the existing Nursery Crop Insurance Provisions and the Nursery Frost, Freeze, and Cold Damage Exclusion Option will be restricted to the 1999 crop year only.

63 Fed. Reg. 50965-66. This decision created the following situation:

- RMA directed reinsured companies to provide two different sets of coverages for the policy year starting October 1, 1998.
- The producer could wait until November 15, 1998, to pick his coverage terms.
- Regardless of the coverage picked, coverage would attach as of October 1, 1998.

NCIS' members were affected adversely by RMA's decision to permit the concurrent sale of two different coverages. First, RMA's authorization of the sale of both the coverages resulted in significant administrative and financial burdens to NCIS' members. Second, RMA's authorization of the sale of both coverages permitted adverse selection and created moral hazard risks that undermined the ability of NCIS' members to adjust losses and protect the nursery program and their own reserves from fraud and abuse.

The 1998 Nursery Rule created additional moral hazard risks when it adopted a "plant price schedule" for establishing the values of undamaged plants and the maximum amounts to be paid for damaged insurable plants. The plant price schedule provides both the variety of nursery plants that a producer may insure and the value, based on container size, at which a producer may insure a particular nursery plant.

FCIC's uniform 1999 price plant schedule contained enough anomalies to promote moral hazard risks. There are numerous examples where less mature plants have been assigned greater insurable prices than more mature plants. Two examples are illustrative:

- The three gallon size of Bloodgood Japanese Maple is assigned a value of \$25.68, whereas the two and four gallon sizes are assigned values, respectively, of \$26.48 (\$1.10 more) and \$36.30 (\$10.62 more).
- The three gallon size of Burgundy Lace Japanese Maple is assigned a value of \$22.50, whereas the two and four gallon sizes are assigned values, respectively, of \$28.00 (\$5.50 more) and \$48.25 (\$25.75 more).

Such anomalies are unjustified and provide an opportunity for unscrupulous growers to exploit the moral hazard by inducing losses to plants after they have established substantial value, but before incurring the additional expense of taking them to the next level of maturity.

1996 Prevented Planting Rule

Prior to 1994, prevented planting losses were compensable for a number of years under policies issued directly by the FCIC or issued by private insurance carriers and reinsured by FCIC. Such coverage, however, historically was not mandatory, thereby requiring producers desiring such coverage to obtain it through an endorsement and paying an additional premium. Starting with the 1995 crop year (January 1 through December 31, 1995) offering prevented planting coverage became mandatory pursuant to the Act, as amended by the Reform Act. 7 U.S.C. § 1508(h)(7). RMA instituted, therefore, changes in the FCIC-approved forms of insurance policies to incorporate prevented planting coverage commencing with the 1995 crop

year. This new form of prevented planting coverage became available for spring planted crops in 1995 (as part of the 1995 reinsurance year, i.e., July 1, 1994, through June 30, 1995) and for fall planted crops in 1995 (as part of the 1996 reinsurance year, i.e., July 1, 1995 through June 30, 1996).

On November 8, 1995, RMA announced, through proposed rules published in the Federal Register on that date, contemplated changes in the regulations and related insurance policy provisions dealing with prevented planting losses. The proposed prevented planting rules, with some modifications, were declared effective November 30, 1995, as final rules promulgated by the FCIC effective for the 1996 crop year starting January 1, 1996 (the “1996 Prevented Planting Rule”) 60 Fed. Reg. 62710-30 (1995).

Based on the discussion in the Federal Register of comments received when the 1996 Prevented Planting Rule was published, numerous objections to the proposed prevented planting rule were lodged. Although the comments raised a substantial number of points, a predominant theme of many of the comments was that the proposed rule, if adopted, would be actuarially unsound and, accordingly, expose reinsured companies to excessive losses not contemplated either by the premiums to be charged to producers or by their Plans of Operation for the 1996 reinsurance year, inclusive of spring planted crops in the 1996 crop year. Commentors expressed this point in various ways, including noting the expansion of coverage without adequate premium increases and creation of adverse selection and moral hazard risks.

When it published both the proposed prevented planting rule and the 1996 Prevented Planting Rule, RMA acknowledged that implementation of the regulatory changes would expand coverage for producers in several respects. Its responses to the comments, however, maintained that the federal crop insurance program would remain actuarially sound because of premium rate

increases to be implemented that would increase producers' effective premiums nationally in the range of 6 to 7%.

The principal changes made by RMA when it adopted the 1996 Prevented Planting Rule and the manner in which they increased the indemnity exposure of approved insurance providers were:

- Producers who purchased MPCCI policies became entitled to a prevented planting guarantee equal to 25% of the production guarantee for timely planted acreage (20% for hybrid corn seed and 17.5% for cotton, ELS cotton, and rice) when a substitute crop was planted for harvest in the same year. This provided coverage in excess of coverage available previously, thereby increasing insurance providers' indemnity exposure and doing so unduly without an appropriate premium increase.
- The 1996 Prevented Planting Rule allowed prevented planting losses to be paid on optional unit acres designated by producers instead of limiting indemnity payments based on a proration of acreage across all optional units. As USDA's Economic Research Service ("ERS") found when it performed a cost-benefit analysis, this change increased the likelihood of greater indemnity payments for several reasons. First, it permitted producers to declare their highest risk and/or least productive land for prevented planting loss recovery purposes. Second, it enabled producers to designate their prevented planting acreage as an entire unit, thereby permitting

them to collect an immediate indemnity payment equal to the adjusted liability. Third, the change eliminated the likelihood that, notwithstanding adverse weather conditions, prevented planting coverage would not be available on a given unit subject to prorating.

- The Final Prevented Planting Rules also permitted producers to obtain prevented planting guarantees for both crops in a double crop rotation.

When ERS performed a cost-benefit analysis on the proposed prevented planting rule, it identified the anticipated effects of implementing the rule and expanding indemnified risks. That analysis also relied on RMA's judgment that an average 6 to 7% premium increase, on a nationwide basis, would deal with expanded indemnification risks. The analysis appropriately noted, however, that a number of producers would have premium increases substantially in excess of the 6 to 7% level because they farm land subject to substantially greater prevented planting exposure. Producers in such circumstances were anticipated to face premium increases approximating 30% in order to be paying an actuarially sound premium.

Assuming for purposes of this discussion that RMA correctly calculated what appropriate premium increases would be to achieve an actuarially sound federal crop insurance program, inclusive of the expanded prevented planting coverage mandated under the 1996 Prevented Planting Rule, reinsured companies never obtained the benefit of any such increases with respect to spring planted crops in 1996. Most fundamentally, RMA failed to make any prevented planting rate changes for 1996 spring planted crops, thereby expanding coverage and indemnity risks without corresponding premium increases for spring planted crops. In fact, ERS' cost-

benefit analysis acknowledged that no rate change was to be made for 1996, but that point never was disclosed in RMA's responses to any of the comments questioning the actuarial soundness of the proposed prevented planting rule. In addition, RMA operated on the premise that producers with little prevented planting risk would decline the additional coverage and obtain a credit against their premium obligations, whereas producers with the greatest risk would elect to maintain prevented planting coverage despite the increased premium cost. In describing this scenario, RMA entirely failed to take into account two critical factors when it decided to implement the 1996 Prevented Planting Rule. First, it failed to acknowledge that the anticipated responses of producers would exacerbate the adverse selection risks intrinsic to the 1996 Prevented Planting Rule. Second, it failed to acknowledge that it has no statutory authority to increase premium rates in excess of 20% per year, as explicitly provided in 7 U.S.C. § 1508(i). Thus, RMA not only implemented the 1996 Prevented Planting Rule in violation of fundamental principles of sound insurance underwriting, it also did so despite direct statutory mandates to improve the actuarial soundness of the federal crop insurance program coupled with a statutory prohibition against increasing premiums to the level commensurate with the risks associated with increased prevented planting coverage. Of course, those serious errors and omissions were incidental to RMA's most egregious error and omission, i.e., failing to implement any premium increase with respect to spring planted crops in 1996.

In sum, reinsured companies' experience with the 1996 Prevented Planting Rule, as well as the 1998 Nursery Rule, leaves NCIS in agreement with OIG's position that RMA's research and development must improve. An appropriate alternative is to place more of these functions with the private sector, using either the authority already contained in 7 U.S.C. § 1507(c)(2) or expanded authority provided by new legislation.

Issue 5 – Optional Unit Structure

OIG raises as its fifth issue dividing a producer's land into optional units for crop insurance purposes. This is an appropriate issue to raise, but OIG misapprehends the problem.

Permitting a producer to divide land into units is not itself a problem. The problem with the optional unit system is that RMA sometimes adopts regulations and writes policy terms which permit manipulation of the system to its detriment. An example is RMA's mistake in the 1996 Prevented Planting Rule of permitting producers to isolate prevented planting coverage to higher risk units rather than allocating it proportionately among all units, as had been the case until the 1996 crop year. In fact, ERS questioned this change when performing its cost-benefit analysis of the proposed regulations.

In short, there is nothing wrong with having optional units as such. The vice only arises when RMA makes a separate change in coverages, as it did with prevented planting, that permits a producer "to game" the system. Accordingly, the optional unit issue really should be treated as an example of OIG's Issue 4, RMA's need to improve its research and development functions.

Issue 6 – CAT Gains

OIG raises two issues about the CAT portion of the federal crop insurance program. One involves declining program participation by limited-resource producers. The other criticizes CAT revenue of reinsured companies.

The Private Sector Is Addressing CAT Coverage for Limited-Resource Producers.

NCIS agrees that RMA and reinsured companies together must redouble efforts to place CAT coverage for limited-resource producers. NCIS and RMA have a task force addressing this issue. This task force is developing a project entitled "Leveraging Risk Management Education Using Crop Insurance Agents" that will provide agent training on effectively working with

limited-resource producers, and a series of fifteen regional conferences targeting crop insurance agents will present this training. NCIS separately has sponsored a symposium on reaching limited-resource producers, provided publicity on the importance of this issue in its publication Crop Insurance Today and by distributing a pertinent USDA/ERS publication, and co-directing with Virginia State University an educational project which will develop materials for increasing delivery of crop insurance to small, socially disadvantaged, and limited-resource producers.

CAT coverage likely would not have declined among limited-resource producers, at least to the large extent noted between 1997 and 1998 by the OIG Report at 27, if FSA had had adequate records, especially electronically available data, on the customer base which it served until the end of dual delivery in 1997. A number of NCIS' members have found that the records transferred to them by FSA through RMA generally were inadequate to support retention of the customer base. In short, the CAT program, as administered by FSA, was in disarray when its customers were to be transferred to the private sector. RMA is working with the private sector to remedy the situation. NCIS believes, therefore, that the regrettable decline in CAT participation by limited-resource producers reported by OIG can be remedied once RMA and the private sector have addressed the problem, including FSA's poor recordkeeping.

NCIS agrees that some economic incentive should be considered to promote sale of CAT coverage to limited-resource producers. Although the OIG Report at 28 states that reinsured companies receive a \$50 administrative fee per policy, that has not been true since the Research Act stripped them last year of even that small incentive. See page 4, supra. A combination of restoring reinsured companies' right to retain administrative fees collected and increasing the companies' share of imputed premium on smaller policies should be considered.

The CAT Program Does Not Compensate Excessively Reinsured Companies.

Without any substantive discussion of the overall economics of the CAT program, OIG recommends “adjusting” (i.e., reducing) the formula for calculating reinsured companies’ gain-loss sharing. OIG Report at 29. For OIG, apparently making money over a short time period warrants changing the rules of the same. Id. at 27. These OIG comments must be read in conjunction with its broader recommendation of considering returning to a government-administered delivery system without taking into consideration the changes that have occurred in the FSA county based delivery system. Id. at 6 and 13-14. FSA has been downsized in personnel by more than 30 percent, resulting in the closing of nearly 400 field offices since 1993. At the same time, FSA has been over subscribed to deliver non-disaster program benefits to farmers in response to the economic crisis. No other USDA agency has a field infrastructure comparable to the private sector insurance industry’s affiliation with 15,000 independent insurance agents. OIG apparently has no institutional memory; otherwise, it would appreciate the overwhelming improvements in the federal crop insurance program since FCIC exclusivity ended in 1980, certainly as measured by markedly increased producer participation.

Not only has OIG conveniently forgotten program history until 1980, it also has ignored evidence developed since 1980 negating its recommendation. OIG also does not understand all of the revenue and expense components of the CAT program.

First, as to the issue of comparative delivery costs, there is compelling evidence that the private sector is more efficient and cheaper than FSA delivery. Significantly, that evidence was developed by FCIC and the GAO.

In 1989, Arthur Andersen & Co. completed for FCIC a study of the relative efficiency of private and public administration of the MPCCI program. At the time of that study, both the government and private sector administered similar programs. The report clearly demonstrated

that the private sector administered the program more efficiently, as measured by the cost of delivery per policy. Since that study was conducted, the participating companies' expense ratios have continued to decline. PW Report at 17.

In addition, the data provided in Appendix V of the GAO Report provided comparative costs to the Treasury of the delivery of CAT through FSA and participating private sector companies. Private sector delivery is achieved at lower net cost to the Treasury per policy and at considerably lower cost per dollar of premium. The following GAO data should answer OIG's question about comparative administrative costs:

	<u>Public (FSA) Sector</u>	<u>Private Sector</u>
Cost per policy	\$79.42	\$76.16
Cost per \$ of premium	22.6%	15.4%

As posed by OIG, the economic issue includes private sector underwriting gain on the CAT program. Here, it provides no independent analysis, instead simply drawing on the discredited GAO Report. As Price Waterhouse found when analyzing the GAO's conclusions on CAT:

The GAO's conclusion regarding the difference between private and public sector costs of delivering the catastrophic program confuses the total cost of the program with the cost of administering the program. This confusion leads to seriously misleading conclusions about relative efficiency of each distribution channel.

It is possible to make a limited comparison of the administrative costs of delivering the program, based on one year's cost data. With respect to administrative expenses, the private sector is marginally more efficient on a per policy basis and significantly more efficient per dollar of catastrophic premium.

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It is not possible to conclude whether the reinsurance of the private sector catastrophic program by the FCIC will result in a long-term net gain or net loss to the Treasury. The reinsurance mechanism produces the opposite underwriting cost result for the Treasury, in gain or loss years, for the private and public sector.

As the GAO Report shows, in a year of catastrophic program underwriting gains, the reinsurance mechanism results in a cost to the Treasury equal to the private sector gain. In a year of underwriting losses, the private sector losses are borne by the private companies, while the Treasury bears the underwriting loss in the public sector.

A less misleading methodology would include in the comparison some projection of long-term underwriting outcomes in both sectors. Reinsurance of the private sector policies results in long-term stable results to the Treasury, while the FSA (public sector) policies produce fluctuating cost to the Treasury. What we cannot predict is whether, in the long term, the gain and loss years in the private sector will offset each other, nor how this will compare with the long-term gains and losses in the public sector.

PW Report at 48–49.

As Putnam, Hayes & Bartlett, Inc. found with respect to the cost of the CAT program, actual private sector delivery costs were lower than were public sector delivery costs. Only because the CAT program experienced an underwriting gain in 1995 did the total cost to the government exceed the private sector's delivery cost advantage. PHB Report at 1. As both consulting firms made clear, however, gains and losses may be program costs, but they are not part of delivery costs. Delivery costs represent the total expenses incurred to sell insurance, whether measured on a per policy or a per premium dollar basis.

Issue 7 – RMA Guidance to Regions and Companies

OIG's Issue 7 faults RMA for providing, at times, inadequate guidance to its RSOs and to reinsured companies. Although OIG cites examples supporting its conclusions, its recommendations avoid a very fundamental issue: Given (i) exclusive delivery of crop insurance by the private sector and (ii) the private sector's significant risk-sharing of underwriting losses (see Table 1, *supra*), is it appropriate for RMA to continue to perform all of the functions criticized by OIG, including maintaining a system of RSOs? Stated differently, is RMA taking advantage of existing options to improve both program performance and cost-effectiveness?

Those really are the benchmark questions to be posed with respect to problems such as those cited under Issue 7.

NCIS can illustrate its point by examining the issue of timely preparation and distribution of program handbooks. For private hail coverage, NCIS performs for the crop insurance industry many of the same functions performed by RMA for MPCCI and CAT coverage (such as developing standard policy forms, sponsoring research on loss measurement, and designing loss adjustment procedures). RMA has the authority to contract with private sector entities to obtain actuarial, loss adjustment, and other services. 7 U.S.C. § 1507 (c)(2). To the best of NCIS' knowledge, this authority has lain dormant instead of being used to avoid duplication of services readily available through the private sector.

In sum, the problems raised by OIG under its Issue 7 are not necessarily solved by looking to RMA for incremental improvement. The issue is far broader, and OIG has failed to pose the appropriate questions and then to pursue analysis of them.

Issue 8 – Compliance Reviews

NCIS' judgment is that Compliance can improve its auditing in several key respects. NCIS believes that RMA management is committed to this process.

It is unfortunate that OIG has not acknowledged (or is ignorant of) a joint government-industry task force which RMA and NCIS formed to improve the effectiveness of Compliance's activities. Substantial progress is being made, and NCIS believes that the task force will complete its work in 1999, with continuing consultation thereafter. Due to the on-going efforts of the task force, NCIS hesitates either to comment on OIG's recommendations or to make alternative recommendations. Instead, NCIS offers the following comments embracing broad principles.

First, audits by Compliance should be consistent, both with respect to establishing priorities and with respect to proposed remediation. The federal banking agencies generally achieve this objective by publishing their examination guidelines.

Second, Compliance should not be driven simply by the greatest dollars paid for indemnity. Under the SRA's risk-sharing formulas, the impact on the FCIC insurance fund is least under policies designated to the Commercial Fund and greatest under those designated to the Assigned Risk Fund. See Table 1, supra. Thus, it makes sense to allocate Compliance resources on the basis that its auditing of underwriting and loss adjustment practices is most likely to yield results that improve the overall program when directed to high dollar indemnities paid on policies in the Assigned Risk Fund. There is a separate, compelling reason to focus on that fund. Quite simply, policies under pilot programs always are placed in the Assigned Risk Fund. Focusing Compliance's efforts on those programs within that fund, therefore, could assist in solving some of the problems reported by OIG under Issue 4.

Third, reinsured companies should not be blamed for policy, procedure, and rating errors. Compliance sometimes faults reinsured companies for their actions even though they result from RMA's errors (such as deficiencies in loss adjustment procedures). This comment rests on NCIS' view that the compliance review process should not simply identify enforcement problems, but should also identify root causes of problems that can lead to suggested corrective actions to prevent their recurrence. So viewed, the process should be a collaborative one and not simply adversarial.

Finally, while Compliance must be rigorous in its auditing, it also must be perceived as fair and reasonable. Reinsured companies have experienced audits by Compliance that resulted in adjustments (i.e., reimbursement of FCIC for some or all of its share of indemnity paid) which

in dollar amount were minimal and which did not represent recurring problems. Quite often, the amount of the adjustment made was substantially less than the cost of identifying it in the first instance. Compliance also must be held accountable for its overstated allegations, especially in those situations where any honest scorecard would show its inability to substantiate the charges initially made. NCIS notes this point because Compliance enjoys limited success in sustaining its positions when challenged by reinsured companies before USDA's Board of Contract Appeals.

Conclusion

The OIG Report utterly fails to provide insight into the public policy debate on the proper role of crop insurance as part of the risk management safety net for American agriculture. OIG's failure is largely self-inflicted, as much can be attributed substantially to its focus on its own distortions of the program's economics and poor methodology. The OIG Report, however, does have a number of useful observations on administrative matters. OIG has made a contribution on those matters, even where its recommendations may not identify the most appropriate solutions.

While the current system has some flaws, they are not fatal to the concept of a successful government-private sector partnership of shared risks and shared gains. The OIG Report most charitably should be viewed as a start and not a conclusion to identifying the renewed challenges facing crop insurance programs as American agricultural producers become more dependent on the global market to reap the benefits of their labor.

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