

**Analysis of the Report to the Secretary of Agriculture by the Office of the Inspector
General on Federal Crop Insurance**

Volume II

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EXECUTIVE SUMMARY

PHB Hagler Bailly has reviewed the recent report on the federal crop insurance program prepared by the Office of the Inspector General (OIG) of the U.S. Department of Agriculture (USDA).¹ We comment here on the soundness of that report's recommendations and conclusions. Our analysis builds upon work done previously in connection with the 1997 report prepared by the General Accounting Office (GAO) on the federal crop insurance program.³ In addition, we have analyzed the economic and financial logic of the OIG report, reviewed the audits upon which it purports to be based, and performed field research involving the private sector's delivery of crop insurance.

Based upon our examination of the OIG report, our analysis of background documentation and data on the program's history and operation, and our previous work on this subject, we have come to the following conclusions.

- Contrary to the implications and assertions of the OIG report, private sector participation has helped the federal crop insurance program meet important goals set for it by Congress (see pages 16-21).
- The OIG report reflects flawed methodology and reasoning, and presents conclusions and recommendations that cannot be relied upon (see pages 21-34).
- Turning crop insurance delivery over to the Farm Service Agency (FSA) would irreparably harm the program (see pages 35-56).
- Maintenance in some form of the current public/private partnership is the only feasible way to achieve program goals (see pages 57-65).

¹ Report to the Secretary On Federal Crop Insurance Reform, U.S. Department of Agriculture, Office of the Inspector General, No. 05801-2-At, Revised as of April 19, 1999.

² Report to the Secretary On Federal Crop Insurance Reform, U.S. Department of Agriculture, Office of the Inspector General, No. 05801-2-At, Revised as of April 19, 1999.

³ GAO Report No. GAO/RECED-97-70, *Crop Insurance: Opportunities Exist to Reduce Government Costs for Private Sector Delivery*, 1997; Kevin Neels, et al., *Analysis and Commentary: GAO Draft Report, Crop Insurance: Opportunities Exist to Reduce Government Costs for Private Sector Delivery*, Putnam, Hayes & Bartlett, Inc., April 1997.

We elaborate upon each of these findings below.

Private Sector Participation Has Enabled the Federal Crop Insurance Program To Meet Important Goals Set for It by Congress

In 1980, with the passage of the Federal Crop Insurance Act, Congress established the current public/private partnership that is the basis for the crop insurance program. At this time Congress established as a goal the creation of a crop insurance program that was universally available and that could serve as an alternative to ad hoc disaster assistance. Federally-sponsored crop insurance is now widely relied upon by farmers, lenders, and other members of the agricultural community as one of their principal risk management tools, and as a primary form of protection against natural disasters and other perils (see pages 16-21).

In the course of achieving Congress's goal, the federal crop insurance program has compiled a record of accomplishment:

Participation in the program by eligible farmers is now widespread. With the help of the private sector the participation rate increased from a low of 10 percent in 1980, to 70 percent today, well above the level called for in 1980 by Congress (see pages 17-19).

The scope of the program has expanded dramatically. In the years following the passage of the 1980 Act, the number of county crop programs (i.e., insurance contracts for a particular crop in a particular county) grew from under 5,000 to more than 15,000. By 1998 the number of crops for which insurance was available had increased to 65, from 28 in 1980 (see pages 16-17).

Administrative costs have been contained. The impressive expansion in the crop insurance program cited above has been achieved at a surprisingly modest cost. On an inflation-adjusted per-insured-acre basis, both reinsured company administrative costs and total program administrative costs have declined since the mid-1980s (see page 19).

The private sector has assumed an increasing degree of risk. By 1992 the share of risk premiums retained by the private sector had risen to 67 percent. In subsequent years this percentage fell slightly, but then rose sharply with the 1996 reforms. In 1997 it rose further,

reaching 75 percent. The 1998 Standard Reinsurance Agreement (SRA) goes even further in assigning risk to the private sector (see page 20).

The OIG Report Reflects Flawed Methodology and Reasoning, and Presents Conclusions and Recommendations that Cannot Be Relied Upon

We find numerous methodological flaws in the OIG analysis (see pages 21-34). They are detailed below.

OIG misstates the degree of risk assumed by the private sector. A key conclusion of the OIG report is that the private companies that participate in the program are insufficiently at risk for losses experienced in connection with the policies they sell and service. The premise of this statement – that reinsured companies bear minimal risks – is false. All of the conclusions that the OIG report draws from this faulty premise are unreliable (see pages 21-26).

OIG's analysis focuses on a short and atypical time period. The OIG report asserts that private companies are making too much money from their participation in the program. The report focuses on the underwriting gains earned over the past four years. However, this period includes the most favorable four consecutive years of loss experience in the program's sixty-year history. The only way to evaluate the financial integrity of the program is to evaluate it over the full loss cycle. The OIG report does not do this (see pages 26-29).

OIG's audit approach cannot support the sweeping charges made in the report. The OIG has described its report as a summary of past and ongoing audits of the crop insurance program (see page 29). The audit approach taken by OIG, however, does not support the report's conclusions or recommendations (see pages 29-32):

- Audits are frequently based upon judgmental and/or biased samples that cannot support conclusions regarding the frequency or severity of the cited problems. Doing so is akin to a doctor concluding based on his experience that everyone is sick, or a policeman concluding that everyone is a criminal.
- Many audits are based upon samples too small to provide confidence in the report's conclusions.

- Instances in which actions have been “questioned” by OIG are treated as though they represent confirmed problems. Information on how these questions have been resolved is never presented.

OIG’s report raises new issues and criticisms not supported by prior investigations. OIG errs both in misrepresenting its prior work and in drawing major policy conclusions based on insufficient or nonexistent evidence (see pages 32-34). Its report contains numerous instances of such overreaching:

- No audit cited by the OIG supports its claim that “Company Revenue Increased At the Expense of Good Program Management.”
- The report identifies, as the root cause of the problems it claims to find, the allegation that the reinsured companies do not share sufficiently in the risk of crop losses. As we show, however, the premise of this conclusion is incorrect. The reinsured companies in fact bear substantial risk.
- The report claims that there is “Pressure on loss adjusters to rubber-stamp policyholders’ loss claims.” The audits cited to support this claim, however, simply document adjuster errors. They provide no evidence of pressure on the part of the reinsured companies to “rubber-stamp” claims. Prior work by FSA contradicts this assertion, stating that “overall loss adjustment performance is acceptable.”
- The OIG report errs in drawing broad conclusions from examinations of experience with a small number of very specialized products. The OIG report cites an audit of crop insurance on fresh market tomatoes, raisin losses, and the nursery crop insurance program. Little attention is paid to crops such as wheat, corn or soybeans that are of huge economic significance both to the agricultural economy and to the crop insurance program. The single instance that did examine a major crop focused on a limited geographic area that was not climatically suited to its production (see pages 33-34).

Turning Crop Insurance Delivery Over to the Farm Service Agency Would Irreparably Harm the Program

There is little in the record of the FSA and its predecessor agencies to inspire confidence in its ability to carry out the delivery of an actuarial sound and economically feasible insurance program. However, there is much to suggest that turning delivery over to the agency would irreparably harm the program (see pages 35-56). Under FSA delivery many problems are likely:

Major reductions in sales effort will occur. Historically, FSA's clientele has come into FSA's offices to enroll in programs offering some future financial benefits. Selling crop insurance, however, is currently the task of professional, trained insurance agents who generally operate not at their offices but in the field with the client. The organizational structure and limited resources of FSA will not allow FSA, however, to take the sale of the product to the farmer (see pages 41-43).

Program integrity will suffer. The organizational structure and management of FSA programs at the local level does not inspire confidence in the objectivity of decisions regarding liability for losses when the decision makers are elected by the farmers who are making the claims. At best, there would be an apparent conflict of interest and at worst decisions would in fact favor the farmers over program integrity. The agency's record of delivering agricultural program benefits to farmers suggests that the same standards and procedures would be applied to crop insurance programs. Past behavior of the agency suggests a tendency to bend the rules in order to get money out the door. Under public delivery one could anticipate similar biases and similar behavior on the part of FSA (see pages 38-41 and 43-44).

Re-equipping FSA for public delivery would require major expenditures. The current FSA has little experience with crop insurance delivery, and lacks the personnel, organizational structure, and information systems needed to carry out this function (see pages 46-51). The one-time costs associated with creating within FSA even a rudimentary delivery system would undoubtedly be very substantial, reaching \$500 million or more (see pages 46-54). These costs include:

- Costs of hiring new staff, estimated at \$44 million.

- Costs of developing the information systems needed to support delivery of crop insurance, estimated at approximately \$200 million.
- Costs of maintaining private delivery capability during the transition period, estimated at over \$265 million.

Public delivery is more expensive on an ongoing basis. Available evidence indicates that public delivery is more expensive than private delivery per policy, and substantially more expensive per dollar of coverage sold (see pages 55-56).

Maintenance of the Current Public/Private Partnership Is the Only Feasible Way to Achieve Program Goals

Review of alternative approaches to crop insurance delivery indicates that maintenance of the current public/private partnership is the only way to achieve program goals (see page 57-65).

A purely private multiple peril crop insurance program designed and delivered by private insurance companies without government assistance or control would not meet the objectives of the program (see pages 59-62).

- Without public support, rates would be higher than those offered by the present system.
- Without the current universal service requirement, farmers with unfavorable loss histories would be denied coverage.
- The program would likely be more limited in terms both of the geographic areas in which it would be available and the crops and perils it covered.
- As a result of all of these factors, participation rates would be significantly lower than at present.

A purely public delivery system would be no more capable of meeting program objectives (see pages 62-65).

- Entitlement delivery mentality coupled with relaxation of compliance mechanisms would degrade program integrity.
- The public delivery infrastructure has been downsized over the last five years to the point that it is inadequate to effectively deliver crop insurance.
- Private investment in research and development on new products is likely to be discouraged due to the lost control over sales and delivery.
- Opportunities for political intervention in program operation would multiply.
- Erosion of actuarial soundness is likely.
- Intensity of the sales effort and accessibility of farmers to the program would decline.
- Substantial reductions in participation are likely, with resulting reductions in availability of commercial farm credit.
- Reduced participation would encourage a return to the former ad hoc system of providing disaster assistance.

It is clear that neither the private sector nor the public sector is capable by itself of achieving important goals set by Congress for the crop insurance program. A partnership between the private sector and the Risk Management Agency is essential.

ABOUT THE AUTHORS

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INTRODUCTION

We have been asked by Morrison & Hecker LLP on behalf of National Crop Insurance Services, Inc. (NCIS) to evaluate the analysis, conclusions, and recommendations contained in the March 15, 1999, OIG report on the crop insurance program. The program currently is administered through a partnership between the Risk Management Agency (RMA), an arm of the USDA, on behalf of the Federal Crop Insurance Corporation (FCIC) and the private insurance companies that are members of NCIS. This report summarizes our findings.

The report first presents an overview of the policy aims of the crop insurance program since its origin in 1980 and, in greater detail, a review of the performance of the program since then. In particular, the first section discusses the considerable growth of the program in both size and scope over the years, and in the numbers of participating farmers. At the same time, the report shows, administrative costs have been tightly controlled, and the private insurance companies have taken on increased risk. This review shows that, contrary to the assertions of OIG, the program is actually functioning well and achieving important goals set for it by Congress.

Against the historical backdrop, the second section demonstrates that the OIG's basis for its reasoning is unsound, as are its analysis and conclusions. The OIG underestimates the extent of risk assumed by the private sector, our report shows, and it extrapolates results from an unreasonably brief, and uncharacteristic, time period. Further, the OIG uses an unreliable sampling procedure for auditing cases, leading it to draw broad conclusions based on isolated instances. Similarly, the OIG makes assertions that are outside the purview of its report, unrelated to the issues at hand, or unsupported by evidence.

The third section demonstrates why turning over the insurance delivery function to the FSA, as suggested by the OIG, would be a critical setback to the program. Not only does FSA's history argue against such a move, the agency's current capabilities and technology are insufficient to support it. Creating the infrastructure and meeting the staff and training requirements (already in place in the current system) to enable FSA properly to administer the function would be astronomically – perhaps prohibitively – costly, the report shows.

Finally, the report concludes that the continuing partnership of public and private-sector entities is the surest way to guarantee future success of the federal crop insurance program.

The passage of the Federal Crop Insurance Act of 1980 (1980 Act) marked the birth of the present insurance program and the start of the public/private partnership that has been the foundation for its success. With the passage of this act, Congress for the first time embraced the goal of establishing a program that could provide protection for all farmers in all regions, with the intent that it replace the costly traditional system of ad hoc agricultural disaster assistance appropriations and payments.

It was hoped that this insurance-based risk management system would be more reliable and more equitable in responding to losses experienced by individual farmers. Although the system of ad hoc disaster assistance that Congress sought to supplant was generous – between 1974 and 1980 it dispensed approximately \$436 million annually to farmers⁴ – it was not always reliable. Requests for assistance had to be filtered through the political system, with predictable results. Widespread disasters caught the attention of Congress, and were likely to generate prompt responses. Localized problems might not attract attention even if the affected farmers' losses were severe. Farmers located in the districts of powerful congressmen were more likely to receive assistance than farmers whose representatives had less seniority and influence, or who were not members of key committees. Thus, although the ad hoc system undoubtedly provided important assistance to many victims of disasters and agricultural losses, it was not something that farmers and their lenders could count on. And there was no guarantee that farmers with similar needs would, in fact, receive similar levels of assistance.

The crop insurance program, it was hoped, would provide a rule-based method of protecting farmers from crop losses that was more consistent and equitable than the system it was designed to replace. In the crop insurance program the rules were specified up front and were to be reliably and consistently applied. At the start of the planting season, an insured farmer would know what he could expect if weather or some other covered peril reduced his yields. Farmers borrowing to cover planting expenses could present documentation of their insurance

⁴ General Accounting Office, *Disaster Assistance: Crop Insurance Can Provide Assistance More Effectively than Other Programs*, GAO/RCED-89-211, September 20, 1989, p. 12.

coverage to lenders as part of their loan application, something that was not possible under the ad hoc system.

To the extent that farmers contributed through the payment of insurance premiums toward defraying the cost of the system, it was also hoped that the crop insurance program might place less of a burden on the federal treasury. There has never been an expectation that the program could be supported entirely by the premiums paid by farmers. However, in comparison to the alternative of ad hoc disaster assistance funded out of general revenues, any contribution by farmers represented a net savings to the federal treasury.

The fundamental public policy objectives of the federal crop insurance program have been substantially achieved, as discussed below.

Recent budgetary pressures have affected the crop insurance program in two ways. First, in order to control and smooth the costs of the program, risk sharing with the private sector has become a more significant tool. During periods of loss in the program, private companies now are obligated to pay out a much larger share of total indemnities than they previously did. From the point of view of the public sector, these private-sector underwriting losses represent net inflows into the system, reducing the demands that large-scale disasters place on the federal budget and simplifying the task of assuring adequate funding for the program's long-term viability. Second, subsidies paid to reinsured companies to cover their administrative and operating expenses have been reduced significantly.

The ability of the crop insurance program to achieve congressional goals clearly depended on its gaining a high degree of participation among the nation's farmers. There was no way for the system to compensate uninsured farmers for losses they experienced. If losses were widespread and those uninsured farmers were numerous, they would be able to petition their representatives in Congress for relief. Experience indicated that Congress would be likely to respond favorably to those petitions.

Recent changes in agricultural policy have lent added importance to the role of the crop insurance program. The rationale behind many of these changes has been to allow market forces to play a larger role in determining what and how much is grown, and how much is paid for it.

Necessarily, the shift toward a more market-based agricultural economy exposes producers to a greater degree of economic risk. The crop insurance program serves as part of the safety net for farmers, mitigating the effects of natural disasters and providing a vital tool for the sensible management of economic risk.

THE PRIVATE SECTOR HAS IMPROVED THE PERFORMANCE OF THE CROP INSURANCE PROGRAM

Many evaluations and criticisms of the crop insurance program go seriously awry because they fail to take an appropriately long-term view of the program's performance and evolution. The current structure and organization of the program have developed over a considerable period of time as Congress, the USDA, and the private companies who participate in the program have struggled, debated, and experimented in a search for ways of achieving the program's goals. A look at the program's history sheds light on why the program is as it is, and on the wisdom of suggestions for changing it. In addition, because of the nature of the program's loss cycle, the only way to gain a real understanding of its economics is to examine its financial performance over time.

The program's success today – as a universally available alternative to ad hoc disaster assistance – and its realization of important goals set by Congress have occurred as the program has evolved, experiencing tremendous growth in the number of crops covered and increasing levels of participation by eligible farmers. At the same time, administrative costs (adjusted for inflation) have steadily declined since the mid-1980s and the degree of risk assumed by the private sector has risen.

The Scope of the Program Has Expanded Dramatically

In the years following the passage of the 1980 Act, the size and scope of the program expanded dramatically. The number of county crop programs (i.e., an insurance contract for a particular crop in a particular county) grew from under 5,000 in 1980 to more than 15,000 in 1993. This rapid increase was primarily due to the entrance of existing crop programs into new counties. By 1998

the number of crops for which insurance was available had increased to 65, from 28 in 1980, and nearly all of the nation's counties were represented in the crop insurance program.⁵

Participation in the Program by Eligible Farmers Has Become Widespread

With the help of the private sector the participation rate, defined as net insured acres divided by total eligible acres, also increased throughout the 1980s and into the 1990s (see Exhibit 1). From a low of 10 percent in 1980, participation grew to 32 percent by 1993. Although this growth represented a major expansion, Congress was concerned about the program's failure to achieve the goal of 50 percent participation that had been set in 1980. Widespread crop losses caused by the floods of 1993 and calls by uninsured farmers for federal disaster assistance prompted a reexamination of the program that eventually led to passage of the Federal Crop Insurance Reform Act of 1994 (1994 Act).

The connection between the low participation rates that the crop insurance program had achieved and the ongoing demands on Congress for ad hoc disaster assistance were clearly recognized at the time:

Past ad hoc disaster assistance has been largely the result of an insufficient level of participation in the Federal crop insurance program. Participation in the program has remained relatively low even though the government pays an average of 25 percent of the insurance premium and covers a substantial part of the program's administrative expenses as well as insurance losses in excess of the premium collected under the program.⁶

The 1994 Act included a number of provisions aimed at altering this state of affairs. Most notable among them was a provision making enrollment in the crop insurance program a precondition for participation in many of USDA's benefit and support programs.

⁵ Barry K. Goodwin and Vincent H. Smith, *The Economics of Crop Insurance and Disaster Aid*, Washington, D.C. The AEI Press, 1995, Table 3-3, p. 50.

⁶ H.R. Conf. Rep. No. 111, 103rd Cong., 1st Sess. (1993), reprinted in 1993 U.S.C.C.A.N. 378, 1993 WL 181528.

At the time the 1994 Act was passed, participation in the program was expected to increase to 80 percent.⁷ These hopes could not have been realized without assistance from private insurance companies. Only the private companies could supply the sheer manpower needed to deliver the new catastrophic crop insurance product to the nation's farmers; the government simply did not have sufficient resources to do the job. Kenneth D. Ackerman, Manager of the FCIC, acknowledged the critical importance of the role of the private sector:

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 given a choice and given a reasonable marketing effort by the private sector, that the bulk of this business will in fact go to private agents.⁸

Although the implementation of the 1994 Act represented a major challenge, the private sector rose to the occasion. The new program offering catastrophic insurance coverage was implemented successfully. In the year following passage of the 1994 Act, participation rates rose to 88 percent. Beginning in 1997, the private sector assumed exclusive responsibility for the delivery of catastrophic insurance coverage in fourteen states and in 1998 assumed similar responsibility in all other states. Although participation rates have fallen somewhat since the repeal of the 1994 Act provision that made crop insurance a prerequisite for receipt of agricultural program benefits, the rates still exceed 70 percent, well above the 50 percent goal set by Congress in 1980.⁹ Much of the drop in participation since 1995 can be attributed to a drop in participation in catastrophic risk protection. Participation in the CAT program was nearly 50 percent in 1995 and dropped to 25 percent in 1998 (see Exhibit 2). Participation in the buy-up

⁷ Review of the Administration's Federal Crop Insurance Reform Proposal, Part 1 (Hearings), 1995-CIS-H161-1, March 25, 1994, p. 26. Typical of the statements made at this time was: "The change made in this bill will improve the delivery and coverage of Federal crop insurance programs by offering crop producers premium-free catastrophic insurance coverage for crops. One of the main reasons the current program is inadequate is because of lack of participation. This bill provides strong incentives to encourage crop producers to purchase additional coverage from private insurers." Statement of Rep. Quillen, *Cong. Rec.* 140, August 5, 1994, p. H6993.

⁸ Hearings, 1995-CIS-H161-1, p. 30.

⁹ The prerequisite requirement was modified in the Federal Agriculture Improvement and Reform Act of 1996.

program did increase – from 42 percent in 1995 to 48 percent in 1998 – but not enough to offset the decline in the CAT program.

In order to assure that crop insurance is available to all farmers, RMA has required that the private companies participating in the program provide coverage and service to all applicants. Because of this requirement, private companies are precluded from taking many actions that other types of insurers use to contain costs and enhance economic viability. Private companies are required to offer coverage to growers with poor insurance experience, high loss rates, small acreage, or other characteristics that may make them impossible to serve profitably. This requirement adds to the cost of the program in ways that are entirely beyond the control of participating private insurers. However, it does support the social goal of making crop insurance available to all farmers.

Administrative Costs Have Been Contained

The impressive expansion in the crop insurance program cited above has been achieved at a surprisingly modest cost. Total administrative costs for the program have, of course, increased. Given the growth in the scope of the program, however, some increase in administrative costs was to be expected. During this time, total premiums paid increased very substantially, and the percentage of sales made by private companies grew from 36.4 percent in 1983 to 93.2 percent in 1993 and 100 percent currently. However, on an inflation-adjusted per-insured-acre basis both reinsured company administrative costs and total program administrative costs have declined since the mid-1980s.¹⁰ The large drop in cost per-insured-acre from 1994 to 1995 is a result of a 136 percent increase in the number of insured acres during this time period. Dramatically expanding the scale of the crop insurance program while maintaining this degree of tight cost control is an impressive achievement for which all parties to the public/private partnership deserve much credit.

¹⁰ This finding was first reported in our March 1997 report, and reconfirmed through examination of more recent data.

The Private Sector Has Assumed an Increasing Degree of Risk

Over time, the reinsured companies have assumed an increasing level of risk. This evolution has coincided with and been supported by the efforts of RMA to put the program on a more actuarially sound basis. The tendency of the program over many years to run chronic losses placed severe constraints on the amount of risk the private sector was able to bear. Under these circumstances retention of risk was tantamount to providing premium subsidies. This fact was recognized clearly at the time of passage of the 1994 Act.

Crop insurance has chronically lost money. Since 1981, the Federal Crop Insurance Corporation's (FCIC) insurance operations have produced an overall "loss ratio" of about 1.47. That means that we have paid out about \$1.47 in claims for every \$1.00 collected in premiums and premium subsidies, not counting overhead costs. Any private business posting these numbers would have gone bankrupt years ago.¹¹

As premiums have risen and long-term loss ratios have begun to fall to levels called for by Congress, the amount of risk borne by the reinsured companies has increased.¹² Exhibit 3 shows the percentages of risk premium ceded to the government and retained by the reinsured companies over the period from 1992 through 1997. By 1992 the share of risk premium retained by the private sector had risen to 67 percent. In subsequent years this percentage fell slightly, but then rose sharply with the 1996 reforms. In 1997 it rose further, reaching 75 percent. The 1998 SRA goes even further in assigning risk to the private sector.

The Program Is a Success

Even this brief review of the history of the program demonstrates clearly that it is a success. It has achieved important goals set by Congress. Although the program has expanded dramatically,

¹¹ H.R. Rep. No. 103-649 at 48-49 (1994), reprinted in 1994 U.S.C.C.A.N. 2516, 2547-2548.

¹² The 1994 Act requires that the multiple peril crop insurance loss ratio be reduced to 1.1 by October 1, 1995. H.R. Conf. Rep. No. 111, 103rd Cong., 1st Sess. (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1993 WL 302291.

costs have not exploded. High levels of participation have been achieved. Loss ratios have fallen dramatically as the actuarial soundness of the program has improved. Risk sharing with the private sector has made the funding requirements of the program more predictable. This record of accomplishment contrasts sharply with the alarmist tone of the OIG's report. The program is not by any means in crisis. In fact, it is working.

As stated above, we find significant flaws in OIG's analysis and reasoning, and disagree strongly with many of OIG's conclusions and recommendations. We take particular issue with OIG's recommendation that consideration be given to turning the function of delivering crop insurance over to the FSA. We find nothing in OIG's report that supports such a recommendation, and there are many reasons to believe that this proposal, if adopted, would increase the program's cost and risks, irreparably damaging the program. We present data supporting each of these points in the following sections.

OIG'S METHODOLOGY IS FLAWED

We find numerous methodological flaws in the OIG analysis. It contains factual errors. It draws sweeping conclusions based on limited examples and thin evidence. A number of significant conclusions and recommendations are entirely without supporting evidence. These points are elaborated below.

OIG Misstates the Degree of Risk Assumed by the Private Sector

OIG's Criticisms

A key, but erroneous, conclusion of the OIG report is that the private companies which participate in the program are insufficiently at risk for losses experienced in connection with the policies they sell and service. This assertion is stated prominently on the first page of the report:

RMA's current policy of underwriting most of the risk for crop losses has led to problems in program management by both the RMA and the reinsured companies. By assigning low overall risk to the companies, the Government has given company managers little incentive to administer the insurance policies in

accordance with the Government's best interests. Because the reinsured companies incur minimal costs from reinsured losses, they have little reason to deny claims of questionable losses, and no cause to find fault with their own practices.¹³

The premise of this statement – that reinsured companies bear minimal risks – is false. The structure of the current SRA places these companies at substantial risk of loss. We document this fact below. All of the conclusions that the OIG report draws from this faulty premise are unreliable.

The Current Allocation of Risk

The FCIC and each of the insurance companies that provides crop insurance to farmers share in the risk resulting from these insurance policies. The terms of this risk allocation, established in the SRA, are negotiated periodically between RMA, on behalf of the FCIC, and the private sector. Provisions for the premium subsidy, administrative and operating expense subsidy, and reinsurance for CAT and multiple peril crop insurance (MPCI) products are outlined in the SRA. The most recent SRA, dated July 1, 1997, took effect for the 1998 reinsurance year beginning July 1, 1997. The Agricultural Research Extension and Education Reform Act of 1998 (1998 Act) caps subsidy reimbursements at levels below those set in the 1998 SRA, eliminates private companies' contractual right to retain any CAT administrative fees paid by farmers, and establishes the risk-sharing allocations set in the 1998 Act as those applicable in subsequent years.

One of the major themes of the OIG report is that the private sector's share of underwriting risks is minimal. From the risk formulas set forth in the SRA, however, it is obvious that the private sector's share of underwriting risks is substantial. In fact, the OIG fails to recognize the dramatic increase in the private sector's risk sharing under the 1998 SRA. This section provides a general description of the SRA structure and the risks borne by the private sector in the current SRA.

¹³ *Report to the Secretary on Federal Crop Insurance Reform*, U.S. Department of Agriculture/Office of Inspector General, Revised April 19, 1999, No. 05801-2-At, p. 9., p.1

Under the SRA, the company may designate eligible crop insurance contracts to one of three reinsurance funds: Commercial Fund (CF), Developmental Fund (DF), or Assigned Risk Fund (ARF). As the reinsurance premium, the company pays the FCIC a portion of the premiums the company collects from its policyholders. In each reinsurance fund, there may be three types of eligible crop insurance contracts: catastrophic risk protection, revenue insurance, and all other crop insurance. As the names indicate, CAT plans protect the producers against catastrophic losses, and revenue insurance plans provide protection against loss of income resulting from a covered peril. For the ARF, all types of insurance plans (CAT, revenue, and all other) are placed in a single fund in each state.¹⁴

Underwriting losses from these contracts are allocated between the company and the FCIC. Exhibit 4 shows the minimum percentage of retained underwriting losses in relation to net book premium for a company. The percentages depend not only on the type of reinsurance fund and crop insurance policy but also the loss ratio, derived by state and by fund for each company.¹⁵ The first category, defined as “proportional reinsurance” in the SRA, applies if the loss ratio is between 0 and 100 percent. The latter three categories, defined as “non-proportional reinsurance” in the SRA, apply to the company’s book of business after the proportional cessions. For both the DF and CF, the company’s percentage is subject to a minimum. If the company chooses, it may assume a greater percentage of the risk (ultimate net losses and net book premium), and the FCIC would assume the remainder of the risk. The increase in retained share of losses must be in 5 percent increments and may differ for each type of policy in the DF and the CF.¹⁶

Besides sharing the ultimate net losses, the company and the FCIC also share in any underwriting gains. Exhibit 5 shows a company’s percent of retained underwriting gains in relation to net book premium by fund and state. The company’s net underwriting gain or loss for each fund is the total of net underwriting gains or losses for all states for that fund.

¹⁴ Standard Reinsurance Agreement, July 1, 1997, Section II.B.

¹⁵ The loss ratio is defined as the (retained) ultimate net losses divided by the (retained) net book premium.

¹⁶ Standard Reinsurance Agreement, July 1, 1997, Section II.B.

As these underwriting gain and loss shares indicate, the reinsured companies are not maintaining a low level of risk in these policies. Under the CF, the company retains the largest share in gains, but at the same time is exposed to the greatest risks of large underwriting losses (for example, 50 percent of the risk when losses range up to 160 percent of the net book premium). The smallest percentage of retained underwriting losses, 20 percent, applies to the ARF. However, there are limitations as to how much premium the company can place in this type of fund. Contracts may be designated to the ARF by state up to the maximum amount (called the "maximum cession") specified for that state by the FCIC. These cessions range from 10 percent to 75 percent of the total premium.¹⁷ Under the DF, the company will share in less underwriting gains/losses than under the CF but will share in more of the underwriting gains/losses than under the ARF.

It is worth noting in this context that the risks associated with pilot programs are placed exclusively in the ARF. They can account for a significant portion of the risk that companies can assign to the ARF, limiting substantially the ability of companies to place standard policies in this category.

There are two other provisions under the SRA that prohibit any unfair gain on the part of the private companies. First, the SRA requires a minimum for the company's net retained book premium relative to its book of business. Overall, the aggregate retained net book premium (total for all funds and all states) for the company must be at least 35 percent of its net book of business. This required percentage decreases to 22.5 percent if more than 50 percent of its net book of business is in the ARF or if the company designates eligible crop insurance contracts only to the ARF and DF. If the company does not meet this minimum retention requirement, its percentage of liability and premiums for contracts in the ARF will be increased pro-rata from 20 percent until the minimum retention requirement is met.

Second, in order to offset future losses with current gains, each company has a reinsurance account with the FCIC. For a given reinsurance year, if the company's retained

¹⁷ See Standard Reinsurance Agreement, July 1, 1997, Section II.B.1.d for a listing of all state maximum cessions. If the aggregate net book premium for the designated contracts exceeds the maximum cession, each contract will be reduced pro-rata to the maximum cession. The excess amount will be placed in the DF.

underwriting gain for all states and all funds is greater than 17.5 percent of its retained net book premium, FCIC will hold 60 percent of the excess gain in a reinsurance account. If the company's overall gain or overall loss is less than 17.5 percent, then the FCIC will pay the reinsurance account balance to the company until the 17.5 percent is met. If there are insufficient funds in the reinsurance account, the company's overall percentage will not reach 17.5 percent. Funds from a reinsurance year will be returned to the company two years after the first annual settlement for that reinsurance year. For example, any balance remaining from the 1998 reinsurance year will be returned in February 2001.

Besides reinsuring the risk accrued by the private companies, under the SRA, the FCIC also subsidizes a percentage of policy premiums to compensate the company for its administrative and operating revenue expenses (A&O). This A&O payment has been reduced from 31 percent in 1993 to a maximum of 24.5 percent in 1999, representing a reduction of 21 percent.¹⁸ Revenue and group risk coverages are reimbursed at a lesser rate. As stated earlier, on an inflation-adjusted per-insured-acre basis, total administrative costs as well as reinsured companies' administrative costs have declined since the late 1980s.

The loss experience of the reinsured companies exhibits the expected underwriting loss/gain cycle (see Exhibit 6). Over the time period 1992 to 1998 the reinsured companies retained the premiums and losses associated with an increasing share of the overall crop insurance portfolio. For example, in 1992, the reinsured companies retained approximately 67 percent of total risk premium written whereas in 1998, they retained 85 percent.¹⁹

The retention by the reinsured companies of an increasing share of crop insurance premiums has meant their assumption also of an increasing amount of risk. In the recent favorable loss environment this trend toward retaining a greater share of the program's risk has allowed the companies to earn greater underwriting gains than in the past. However, when losses

¹⁸ Agricultural Research, Extension, and Education Reform Act of 1998, Section 532(c).

¹⁹ Statement of Joseph W. Glauber, Deputy Chief Economist, U.S. Department of Agriculture, Before the Committee on Agriculture, Nutrition and Forestry, U.S. Senate, March 10, 1999, p. 9.

²⁰ *Ibid.*

do occur – as they eventually must – the reinsured companies will also be exposed to far greater losses than in the past.

Actuarial Experience of Private Companies

The actuarial experience of the private sector is similar to that of the overall program.²¹ Net gains have been observed in the last few years. For the period 1992 to 1997, these underwriting gains totaled approximately \$825 million (see Exhibit 6), and the average of the annual net underwriting gains since 1996 is over \$300 million.²² However, these gains have occurred during a period when the program as a whole has experienced exceptionally favorable loss conditions. As Joseph W. Glauber stated before the U.S. Senate in March 1999:

While the potential for underwriting gains is large, reinsured companies have also been exposed to large potential losses. For example, had the 1988 drought occurred in 1998, it is estimated that net underwriting losses to the companies would have exceeded \$450 million.²³

OIG's Analysis Focuses on a Short and Atypical Time Period

The performance of the program and of the participating insurance companies can be assessed fairly only over a relatively long period, due to the extremely cyclical nature of the program; short-term evaluation will yield a false profile. Yet this is precisely how the OIG did its analysis – based on a four-year period, and coincidentally one of extremely favorable loss experience. As a result, its conclusions are misleading and unreliable.

A persistent theme of the OIG report is its assertion that private companies are making too much money from their participation in the program. The facts cited in the report to support this assertion focus on the underwriting gains the companies have earned over the past four years:

²¹ The Federal Crop Insurance Corporation and the reinsurance companies shared in the delivery of the catastrophic risk policies until 1998 when the reinsurance companies assumed full responsibility for these policies.

²² Statement of Joseph W. Glauber, Deputy Chief Economist, U.S. Department of Agriculture, before the Committee on Agriculture, Nutrition and Forestry, United States Senate, March 10, 1999.

For the most recent four years, 1995 through 1998, the reinsured companies received a total of \$2.8 billion in revenues, consisting of \$1.7 billion in administrative fees, and \$1.1 billion in underwriting gains.²⁴

The report contains many other statements making similar points.²⁵

Even if one were to assume that the facts cited by the report were accurate (and many do dispute their accuracy and relevance), the overall analysis and the conclusions drawn from it would be unreliable because of the short and atypical period upon which it is based. This period includes some of the most favorable loss experience in the program's history. During this period weather has been favorable, yields have been high, and the large-scale disasters that account for the program's most dramatic losses have been entirely absent. During periods such as this, one would expect to see underwriting gains. Indeed, the absence of underwriting gains during a period such as this would be a sign that something in the program was seriously wrong. One cannot extrapolate from such a period, however, or conclude that on a going-forward basis the private companies will be inappropriately enriched. The only way to evaluate the appropriateness of the underwriting gains of the reinsured companies is to look at their experience and that of the program as a whole over the full loss cycle.

Exhibit 7 shows the relationship between premiums received and indemnities paid out from 1939 through 1998. Over this period the loss ratio of the program has varied widely. Even casual inspection of these data, however, reveals a key fact about the program: Its most severe losses tend to be concentrated in a relatively few years in which widespread natural disasters

²³ *Ibid.*, 9.

²⁴ OIG report, p. 11.

²⁵ For example, on p. 9 it states:

"From 1995 to 1998, the CAT program was transferred from a Government-delivery system program to a fully private delivery program. Over this 4-year period, the total costs for the CAT program were estimated to be about \$778 million. Of this amount \$510 million was paid to the reinsured companies for underwriting gains, excess loss adjustment expenses, and other administrative fees."

Further, on p.10 it states:

"For the reinsurance years 1995 through 1998, gross Government costs totaled about \$8.8 billion, which consisted of \$5.4 billion in indemnities paid to producers, \$2.8 billion for administrative expenses and underwriting gains to reinsured companies, and \$325 million in USDA administrative and related costs."

occur. Such years include the drought years of 1983 and 1988, and 1993, when large-scale flooding inundated much of the Midwest. Such years occur in a random and unpredictable fashion. Large-scale natural disasters such as these 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.

The losses the private sector experiences in a year in which a major disaster occurs can be dramatic. This point was made starkly clear in testimony offered during hearings that led to passage of the 1994 Act:

FCIC Manager Ken Ackermen has indicated in prior testimony that not only did farmers lose big in 1993, but the private reinsured companies did as well at a level of approximately \$83 million in 1993. To put that in perspective, some companies' losses in 1993 exceeded their cumulative profits over the 10 to 13 years they have been involved in the program.²⁶

Because losses in the crop insurance program tend to be concentrated in a few isolated years, the only way for private insurance companies to remain in business is for them to earn underwriting gains and build up sufficient reserves during good years to enable them to pay claims, endure losses, and stay in business during years in which widespread disasters occur. The underwriting gains of which the OIG report is so critical are in fact exactly what one would expect to see – indeed, would hope to see – during such a period.

Because of the highly cyclical nature of the crop insurance program, any analysis of it 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. The program's performance, and that of the companies that participate in it, can only be assessed through an examination of their long-term performance.

²⁶ Testimony of Richard C. Gibson, Chairman of Government Relations on behalf of the American Association of Crop Insurers, Before the Committee on Agriculture, Nutrition and Forestry, Subcommittee on Agricultural Production and Stabilization of Prices, U.S. Senate, May 19, 1994.

The OIG report falls squarely into this trap. The OIG'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 four-year period characterized by exceptionally favorable loss experience. The loss ratios for the crop insurance program during these four years, 1995 to 1998, range from 0.56 to 1.02 (see Exhibit 7). Of the two types of coverage, CAT has observed much better loss ratios relative to the buy-up coverage (see Exhibit 8). 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. In fact, the four years selected by the OIG represent the lowest four consecutive years of loss experience in the program's sixty-year history. The OIG's grounds for concern over the relationship between the amounts being paid to private companies and the amounts being paid in indemnities to farmers will evaporate completely with the next shift in loss ratios.

OIG's Audit Approach Cannot Support the Sweeping Charges Made in the Report

In its report, the OIG asserts on numerous occasions that widespread problems exist that can be corrected only through sweeping changes to program structure and operation. To support these assertions, the report cites a number of audits of the crop insurance program conducted by the OIG. In many cases, however, the OIG's audit approach does not support the array of charges made in the report. For example, audits are frequently based on judgmental and/or biased samples that do not support conclusions regarding the frequency or severity of the cited problems; other audits are based on samples too small to provide confidence in the report's conclusions. And instances in which actions have been "questioned" by the OIG are treated as though they represent confirmed problems, although information on how these questions have been resolved is never presented.

In its report the OIG goes beyond the fact that isolated problems exist to make a number of assertions either explicitly or implicitly regarding their frequency, severity, and significance relative to the program as a whole. For example it states:

Reinsured companies do not have adequate controls to prevent or detect situations that allowed employees, including contractors, to be involved in conflict-

of-interest situations. This caused *substantially* increased risk to the crop insurance program (emphasis added).²⁷

Our reviews have documented a *history* of verification errors by loss adjusters who have cost the Federal crop insurance program *excessive* indemnity payments (emphasis added).²⁸

In the current system, loss adjusters are encouraged to approve questionable claims.²⁹

To support and prove such statements requires more than just evidence of isolated instances of misconduct. Since no one in either the public or private sector has yet found a way completely to eliminate questionable behavior, such instances of misconduct will be found occasionally even in the best-run programs. Labeling them as significant and declaring them signs of a widespread and systematic problem requires first a reliable estimate of the rate at which they occur, and second, evidence that the rate so measured is substantively and unacceptably high. The OIG report fails to provide any such foundation.

In order to provide a reliable basis for estimating the incidence of problems, the cases selected for review must be chosen according to a valid random sampling procedure. All cases in the target population must have a positive and known probability of selection. Only in this way can the results of the audit be used to draw inferences about the severity of the problem in the population as a whole.

The sampling procedures used in the OIG audits frequently fall short of this standard. For example, a major portion of OIG's audit of the fresh market tomato program, which is cited in connection with issues 2, 4, and 8, is based upon a review of five producers who were

²⁷ OIG Report (revised), p. 14.

²⁸ *Ibid.*, 17.

²⁹ *Ibid.*, 2.

“judgmentally” selected.³⁰ In the audit of 1996 prevented planting, which is cited in connection with issues 2 and 3, OIG “judgmentally selected” six states that had the largest and fewest indemnity payments for prevented plantings. It then selected eight counties (within these six states) based on the largest total indemnity in each state. Finally, it “judgmentally selected” 75 claims to review.³¹ In the audit of federal crop insurance claims cited under issues 3 and 8, “OIG regional staffs used their knowledge of county conditions, companies, agents, and/or crops in selecting claims to audit.”³²

Sampling procedures such as these may be appropriate if the purpose is to identify and punish instances of wrongdoing, and thereby to strengthen incentives for compliance with program requirements. The auditor should seek to maximize the probability of detection without regard to the rigors of sampling theory and practice. In such a situation, following the imprecise hints and suggestions of whistle-blowers may be both wise and efficient.

One must exercise extreme caution in generalizing from such biased samples, however. Doing so is akin to a doctor concluding, based on his experience, that everyone is sick, or a policeman concluding that everyone is a criminal.

There is reason for concern over not just how these audit samples were drawn, but also over the number of cases that were examined. For example, OIG’s examination of the transfer of CAT policies to reinsured companies, which is cited in connection with issue 6, focused on two counties out of approximately 3,000 nationwide.³³ This is a very thin set of facts from which to draw sweeping conclusions.

A different type of methodological error infects the OIG analysis, and may seriously undermine the validity of many of the conclusions that it draws. In describing the results of its audit

³⁰ *Audit Report No. 05099-1-At*, September 1997, p. 2.

³¹ *Audit Report No. 05601-5-Te*, *RMA Prevented Plantings of 1996 Insured Crops*, March 1999, pp. 5-7.

³² *Audit Report No. 05601-3-Te* *RMA Federal Crop Insurance Claims*, February 1998, p. 5.

³³ *Audit Report No. 05099-1-KC* *RMA – Transfer of CAT Policies to Reinsured companies*, March 1998.

activities the OIG states repeatedly that after an examination of some set of specific cases it “questioned” the actions of the RMA, the reinsured companies, or the loss adjusters they employ.³⁴ In other instances the report uses similarly tentative language suggesting the possibility of problems without stating that they in fact actually occurred. For example, the report cites a possible situation of conflict of interest in which an agent “could have manipulated indemnity amounts.”³⁵

While it is appropriate in an audit to flag potential problems that warrant detailed examination, flagging them as potential problems does not mean that they represent *actual* problems. That determination can be made only after an inquiry into the facts has been completed. The OIG report and the audits that back it up provide surprisingly little information on how these cases were ultimately resolved. One cannot ascertain whether severe problems were found, or whether, upon closer examination, they proved to have been handled correctly. The alarmist tone of the OIG report and its conclusions are seriously at variance with the tentative nature of much of the evidence cited.

OIG’s Report Raises New Issues and Criticisms Not Supported by Prior Investigations

Although the OIG asserts that its report is “based upon our prior audits and investigations,”³⁶ it raises many new issues and makes numerous claims and recommendations having little or nothing to do with its past work. OIG is guilty both of misrepresenting the basis of its report and of drawing major policy conclusions based on flimsy or nonexistent evidence.

The report asserts in the first issue it raises that “Company Revenue Increased At the Expense of Good Program Management.” No audit cited by the OIG addresses this issue or supports this claim. In its discussion of this issue the report presents a variety of statistics in an effort to create the impression that the reinsured companies are making too much money. These

³⁴ OIG report, pp. 17, 19, and 35.

³⁵ *Ibid.*, 16.

³⁶ Cover letter to the OIG report dated March 15, 1999.

statistics are unsupported by any evaluation framework capable of indicating what level of payment to the reinsured companies is appropriate or inappropriate, or even of providing a proper context for understanding the significance of the data that are presented. The initial version of the report was heavily criticized for presenting statistics that were inaccurate and/or misleading. As a result, the OIG was obliged to present a revised version of the report in which the discussion of issue 1 was substantially changed. Despite these changes, however, the report still fails to provide proper evidentiary support for its assertions.

As the root cause of the problems it claims to find, the report identifies the allegation that the reinsured companies do not share sufficiently in the risk of crop losses.³⁷ As we have shown above, the premise of this conclusion is incorrect. The reinsured companies in fact bear substantial risk. Despite this faulty premise, however, the OIG purports to find support in its audit results for its conclusion. Stating that there is “Pressure on loss adjusters to rubber-stamp policyholders’ loss claims,”³⁸ it cites a number of audits.³⁹ These audits, however, simply document adjuster errors. They provide no evidence of pressure on the part of the reinsured companies to “rubber-stamp” claims, and they certainly fail to establish any connection between these adjustment errors and the degree of risk assumed by the private sector.

The FSA’s own review of the crop insurance program contradicts OIG’s charges. A 1995 report by the FSA on a review of the program’s management stated in connection with the loss adjustment process that “overall loss adjustment performance is acceptable.”⁴⁰

³⁷ OIG report, p. 1.

³⁸ *Ibid.*, 2.

³⁹ *Audit Report No. 05601-3-Te, RMA Federal Crop Insurance Claims*, February 1998; *Audit Report No. 03099-3-SF, RMA 1994 Reinsured Raisin Losses in California*, September 30, 1996; *Audit Report No. 05099-2-At, RMA Nursery Crop Insurance Program*, December 16, 1998.

⁴⁰ *Technical and Organizational Analysis of Risk Management Loss Adjustment Operations; and the Structure of Compliance, and Regional Service Offices*, Volume II Major Findings, draft prepared by Louis J. Blazy et al., FSA, November 30, 1995, p. 19.

The OIG report also errs in drawing broad conclusions from examinations of experience with a small number of very specialized and often newly introduced crop insurance products. In connection with issue 2 the OIG report cites an audit of crop insurance on fresh market tomatoes. In connection with issue 3 it cites an audit of raisin losses. In connection with issue 7 it cites an audit of the nursery crop insurance program. Little attention is paid to crops such as wheat, corn, or soybeans that are of huge economic significance both to the agricultural economy and to the crop insurance program. The single instance that did examine a major crop focused on a limited geographic area that was not climatically suited to its production.⁴¹

The issue is not the way in which the OIG has selected its past audit targets. If the purpose of these audits is to identify problems and initiate actions to correct them, it makes sense to concentrate on the new, unusual, and unfamiliar insurance products where problems are most likely to be found. It is inappropriate, however, to attempt to apply the conclusions drawn from such audits to widely sold products that are well understood and well established, and for which policies and procedures are functioning smoothly and accurately.

The most glaring example of over-reaching on the part of the OIG is its recommendation that the USDA evaluate “the possibility of a government-administered delivery system.”⁴² The report is quick to state that “We did not perform an in-depth analysis of this alternative to return to a Government-administered delivery system.”⁴³ This admission, however, is not enough to inoculate the report against criticism for its suggestion. Indeed, it is grossly irresponsible on the part of OIG to suggest radical restructuring along untested and unevaluated lines of a system relied upon by a majority of the nation’s farmers. The very fact that the OIG has offered this alternative up for consideration has lent it a substance and legitimacy it otherwise never would have achieved. As we will show below, public delivery is a terrible idea.

⁴¹ *Audit Report No.05001-2-Te, RMA Crop Insurance Coverage for Pima Cotton, Popcorn, and Corn in Texas, April 1999.*

⁴² OIG report, p. 3.

⁴³ *Ibid.*

FARM SERVICE AGENCY DELIVERY WOULD SEVERELY DAMAGE THE CROP INSURANCE PROGRAM

The OIG makes the startling and unsupported assertion that it may be desirable to take the delivery function away from the reinsured companies and give it to the FSA. Such a “deprivatization” would reverse nearly 20 years of evolution and accomplishment by the crop insurance program. It also runs counter to a worldwide trend toward greater reliance on market forces and the private sector to achieve important social goals. Public delivery is a dramatically bad idea. In this section we detail the reasons why.

History of the Farm Service Agency

The organization known today as the FSA was originally set up in 1994, and was an amalgamation of several pre-existing agencies: the Agricultural Stabilization and Conservation Services (ASCS), the Office of Risk Management (which ran FCIC), and the farm credit function of the Farmer’s Home Administration (FmHA). Despite the structural and nominal changes throughout the years, the FSA and its predecessor agencies have served the U.S. agricultural community in much the same capacity since the 1930s. (RMA was created as a separate agency within USDA in 1996; today it runs FCIC.)

Current FSA Organization and Responsibilities

The history of FSA and its predecessor agencies does not support the notion that the FSA should be in the business of selling crop insurance. Historically, the FSA’s role has been to administer programs offering future financial benefits to farmers who, once enrolled in an FSA program, could expect a virtually guaranteed financial distribution. Selling crop insurance, however, presents a very different model and product – protection against a future, uncertain risk – and selling that product requires professionally trained agents whose responsibility is full-time risk management, and who operate predominantly in the field with the client. The FSA’s organizational structure and resources are not equipped to handle this function.

Although FSA continues to have a major field organization structure, many of the programs delivered by the agency were significantly altered by the 1996 farm bill, thus causing the

agency to undergo considerable restructuring. As of December 1997, FSA had 2,396 offices that were staffed by 11,399 county office employees. This number – down from the nearly 2,800 offices in 1993 – reflects the closing of more than 300 offices and staff reductions beginning in 1994. Further, the 1998 budget reflects an intent to reduce staffing to 50 percent of present levels and close an additional 500 offices. According to a May 1, 1998, GAO report, currently there are an average of five to six employees per county office, and with the planned reductions, numbers could become as low as two to three. The GAO report suggests that a reduction in FSA staffing and the further closing of service centers may lead to a decline in service provided to the farming community as farmers are required to travel longer distances to receive less personal service. Such staff reductions in the absence of substantial closure of offices have also raised significant management issues relating to efficiency of operations.

These scheduled cuts were temporarily put on hold as a result of the economic problems currently facing U.S. agriculture. This action to postpone the cuts was triggered by an anticipated increase in the agency's workload. The increase was caused by the need to deliver greater levels of its traditional income support programs, such as commodity marketing loans, loan deficiency payments (LDPs), conservation reserve programs (CRP), non-insured assistance programs (NAP) and ad hoc economic assistance. In addition, the agency has been overwhelmed with requests for farm credit assistance. For example, the Fiscal Year 1999 farm credit appropriations were expected to be depleted by early spring. This added demand, combined with a shortage of experienced staff, has caused the agency to triage all loan servicing, thus putting a \$25 billion loan portfolio at risk. Hence, the warning of the 1998 GAO report is now a reality. FSA's ability to deliver programs has been significantly degraded to the point that two- to three-week delays are being experienced on such routine activities as payments of LDPs. In a Senate hearing on crop insurance on April 28, 1999, the agency came under severe criticism from the Senate Agricultural Committee when it was noted that eight months after Congress approved disaster aid, farmers have not been signed up to participate, nor have they received the benefits.

According to the FSA Fiscal Year 1999 budget, the following activities are currently carried out within the agency, which includes each county FSA office:

- Developing program regulations and procedures.

- Collecting and compiling basic data for individual farms.
- Establishing individual farm allotments (marketing quotas) for tobacco and peanuts and (documenting) farm planting history.
- Notifying producers of established allotments (farm marketing quotas) and farm planting histories.
- Determining farm marketing quotas for tobacco and peanuts.
- Conducting referendums and certifying results.
- Accepting farmer certification(s) and checking compliance for specific purposes.
- Issuing marketing cards (tobacco and peanuts) so that production from allotted acreage can be marketed without penalty.
- Processing commodity loan documents and issuing checks.
- Processing production flexibility contract payments and issuing checks.
- Certifying payment eligibility and monitoring payment limitations.

Staff reductions and office closures call into question the feasibility of FSA's taking on the additional task of delivering crop insurance to farmers. Even in the absence of office closures, smaller, less efficient offices will have more farmers to serve and more programs to deliver per employee. Office closures exacerbate the problem. With such closures, farmers will have to travel farther to participate in crop insurance programs.

The extent to which FSA is ill-suited to the task of selling crop insurance has long been recognized by Congress. It is for this reason that Congress encouraged a move to a purely private delivery system, recognizing that this is a task for which the private sector is uniquely qualified. Statements made during the debate over the 1994 Act make this point clearly:

Many current USDA employees – those people now administering the commodity programs – have told me that they want no part of becoming insurance salespersons. And in checking with the department, I have found there is nothing

budgeted to help train and cover the expenses for these local offices to adequately sell crop insurance. The simple fact is that the USDA will not be able to pull off crop insurance sales, and the department knows this. USDA will need – and I think fully expects – the private sector to help deliver crop insurance.⁴⁴

Criticisms of Historical FSA Performance

In recent years, there is a common thread that runs through reviews and criticism of the FSA. It is that the agency has not been able to keep pace with its changing mission in a market-driven agriculture environment. Too often, the agency has not been able to meet consistently or reliably specific program requirements and standards. The agency has been in almost constant reorganization since 1994 in an attempt to integrate delivery of diverse programs such as commodity loan activities, farm credit and crop insurance. In the case of crop insurance, Congress recognized the futility of trying to create a mega-agency and in 1996 reversed the efforts of the USDA to have FSA deliver crop insurance. The FSA is still struggling with the merger of farm credit and commodity loan programs at a time of high demand brought on by a global economic crisis in agriculture.

For example, since acquiring farm credit function of the former FmHA in a reorganization of USDA in 1994, FSA has unsuccessfully been struggling with correcting major deficiencies that have plagued the program for years. GAO identified the farm loan program in a 1990 report, as one of 17 high-risk areas especially vulnerable to waste, fraud, abuse, and mismanagement. The GAO has routinely criticized the loan programs administered by FSA and its predecessor agency, FmHA.

In the direct loan program, some FmHA officials seem to believe that keeping farmers on the land is more important than making prudent lending decisions. In the guaranteed loan program, FmHA's emphasis on making loans has left the impression that the number of loans is more important than their quality. Furthermore, violation of property management standards reflects, in part, FmHA's

⁴⁴ Statement of Rep. Barrett, *Cong. Rec.* 140, August 5, 1994, p. H6999.

having given higher priority to making and servicing loans than to managing inventory properly.⁴⁵

In an October 1994 report, GAO reviewed the FmHA's debt settlement process (i.e., methods to resolve unpaid direct farm loans). It found that the "FmHA does not take sufficient action to identify and recover payments from those with the resources to reduce their debts."⁴⁶ The FmHA field office officials do not always follow the agency's own debt settlement procedures, thereby failing to mitigate the federal government's losses. The GAO further found that the management of the FmHA has placed little emphasis on overseeing the implementation of the agency's policies and practices for ensuring maximum recoveries in their field offices.⁴⁷

In February 1995, the GAO issued another status report on farm loan programs as part of its high-risk series. It reported that the FmHA field office officials had improved their compliance with the agency's standards for servicing guaranteed loans. But, it also found that the officials often failed to implement the servicing standards for direct loans. The GAO concluded that:

As we reported in April and December 1992, FmHA has neither acted as a prudent lender nor enhanced the creditworthiness of the nation's financially stressed farmers . . . the massive amount of money that FmHA has lost, and the amount that is vulnerable to loss, far exceeded the losses that might be anticipated, even for a lender of last resort.⁴⁸

The emergency disaster loan program has also been a target for the GAO's criticisms.⁴⁹ In March 1996, the GAO found negligence on the part of the FSA in its approval policies and its lack of safeguards to protect federal financial interests. As previously noted in the 1994 debt

⁴⁵ Farmers Home Administration's Farm Loan Programs, GAO/HR-93-1, December 1992, p. 18.

⁴⁶ *Debt Settlements: FmHA Can Do More to Collect on Loans and Avoid Losses*, GAO/RCED-95-11, October 1994, p. 9.

⁴⁷ *Ibid.*, 7.

⁴⁸ *High-Risk Series: Farm Loan Programs*, GAO/HR-95-9, February 1995, p. 20.

⁴⁹ *Farmers Home Administration: Problems and Issues Facing the Emergency Loan Program*, GAO/RCED-88-4, November 30, 1987; *Disaster Assistance: Crop Insurance Can Provide Assistance More Effectively than Other Programs*, GAO/RCED-89-211; and *Farmers Home Administration: Billions of Dollars of Farm Loans Are at Risk*, GAO/RCED-92-86, April 3, 1992.

settlement report, the GAO reports that the FSA does not consistently follow lending requirements in its field offices. For example, there is evidence that some FSA field offices do not always verify information on the level of an applicant's disaster loss, debt, or income before approving the loan. The OIG also reported in December 1994 and March 1995 that a majority (six of seven) of emergency loans reviewed were not based on the most current and accurate information available at the time of the loan closings.⁵⁰

In 1998, the GAO again reported that USDA still failed to comply with some of its own loan servicing standards.⁵¹

In these various reviews and criticisms one can discern some common themes. The record of FSA in adhering to specific programmatic requirements and standards has been anything but stellar. Understaffing, uncertainty of funding, lack of technology support, poor change management, increased workload and a failure to reconstruct its human resources with a common vision in support of the delivery of diverse programs have been and remain constant challenges to the agency. This situation does not inspire confidence in the ability of the FSA to take on additional responsibility and protect the integrity of the crop insurance program, a program on which success or failure is judged by the public's confidence that benefits will be immediately available in times of disaster. In addition, the agency has been criticized by oversight organizations for its laxity in adherence to program requirements. This weakness has been particularly noted when the agency was under political pressure to get dollars out the door notwithstanding the need to follow rules and procedures. Similar conflicts would certainly arise in a system of public crop insurance delivery, and one could anticipate similar biases and similar behavior on the part of FSA.

The FSA also has been cited for its historically poor performance in serving minority farmers, and USDA Secretary Glickman has acknowledged the racial prejudice that has existed in

⁵⁰ *Emergency Disaster Farm Loans: Government's Financial Risk Could Be Reduced*, GAO/RCED-96-80. March 29, 1996.

⁵¹ *Performance and Accountability Series: Major Management Challenges and Program Risks*, U.S. Department of Agriculture, GAO/OCG-99-2, January 1999, p. 26.

the department and FSA.⁵² The FSA's record raises a legitimate public policy issue,⁵³ but it is one that is outside the scope of the economic and financial analysis of this report.

Services to Farmers Will Be Reduced Under FSA Delivery

In a number of important respects, service to farmers would be degraded under public delivery.

Sales Efforts Will Be Severely Reduced

Under public delivery of crop insurance, it is reasonable to expect that sales efforts would be dramatically diminished. FSA's current incapacity to meet the sales requirement, combined with the cost of providing the service – including one-time hiring costs, salaries, training, information system and equipment expenditures, and management – would have an extremely detrimental effect on the program and its participants.

The history of the crop insurance program under public delivery has been associated with low rates of participation by the nation's farmers. It was not until passage of the 1994 Act, which mandated that the delivery program be turned over to the private sector, that participation rates began finally to achieve the levels called for by Congress as far back as 1980. It was recognized in 1994 that high levels of participation could be achieved only with major commitments of effort, resources, and personnel by the private sector.⁵⁴

Although exact figures are difficult to come by, the number of agents actively involved in the sale of crop insurance is clearly very substantial. Current estimates place this figure at approximately 15,000. This figure implies an average across the entire United States of about five agents per county. In heavily agricultural areas the number of agents per county will go much higher. Like almost all insurance agents, they are compensated on a commission basis, and

⁵² USDA Civil Rights Action Team Report, <http://www.usda.gov:80/ocfo/crat/p9.htm>, March 11, 1997, 13:34:59 GMT. See also "A Dream, Too, at USDA." Editorial by Dan Glickman, New York Times, January 14, 1999, p. A15.

⁵³ *Pigford v. Secretary*, U.S. Department of Agriculture, Civil Action No. 97-1978, U.S. District Court for the District of Columbia.

⁵⁴ See note 5 (remarks of Kenneth Ackerman, head of the Risk Management Agency).

hence face strong financial incentives to pursue business aggressively. Successful agents are heavily involved in their communities. Often they seek out farmers, rather than waiting for farmers to come to their offices and request application forms. A relatively small number of aggressive, involved agents account for a sizeable fraction of the sales made under the program.

Most agents currently involved in the sale of multiple peril crop insurance also sell other lines of insurance. Their part-time involvement in the crop insurance program is a natural consequence of the nature of the selling season in that program. Because crop insurance is tied to the growing season, sales must take place during two relatively short windows preceding spring and fall planting. During these sales windows, a concentrated effort by agents is required in order to reach out to farmers and enroll them in the program. At other times of the year the program has little for them to do. The option of using these periods to sell other lines of insurance makes it economical for greater numbers of agents to enter and sell the program, and hence more likely that the enrollment process will be completed smoothly even in the face of high levels of participation.

The sales effort under FSA delivery would, it is reasonable to expect, look dramatically different. Given the FSA's traditions and history, one can anticipate that the sales effort would be run out of the agency's network of county offices. Thus, instead of having private agents operating out of multiple locations scattered throughout a major agricultural county, FSA sales personnel would be concentrated at a single location. Getting to a sales agent would be more difficult and less convenient for farmers. The current average of five private agents per county is approximately equal to the total number of personnel currently located in a typical FSA county office. Current budgetary proposals call for substantial reductions in FSA staff levels. It is highly unlikely even during the peak selling season that all FSA staff would be assigned to crop insurance sales since the crop insurance sales period coincides with the peak lending period for the understaffed farm credit program of FSA. For all of these reasons the number of people actively involved in the sales process would likely decline sharply under public delivery. Scheduling a time to sit down with an agent would become dramatically more difficult.

The problems caused by a reduction in the number of sales locations and agents would be exacerbated under public delivery by the reduction in outreach that would almost certainly occur.

Private agents are compensated through commissions on the basis of sales closed. FSA staff, in contrast, are paid a salary that is independent of how much or how little they sell. Under these circumstances FSA staff will be less likely than private agents to leave the office and travel to farmers, and less willing to schedule appointments outside of normal working hours. These and other outreach efforts that have played such a key role in increasing participation levels in the program would be likely to disappear under public delivery.

Ability of FSA To Meet Program Timelines Is Uncertain

As in its capacity to provide adequate sales resources, FSA's ability to meet deadlines is dubious. The agency has an uneven historical record in this regard. In a program with often extremely tight deadlines, such as crop insurance, this is a significant shortcoming.

To avoid the creation of a serious moral hazard problem, crop insurance sales must be closed before the start of the planting season. Policy rates, terms, conditions and language are often finalized only at the last minute, leaving the reinsured companies little time to prepare documents or to train agents. At the other end of the process, it is also essential that lost adjustments be carried out in a timely manner. In part this is a matter of customer service. When a loss occurs, the insured is likely to be in need of funds, and to demand quick turnaround in the processing of his claim. A timely response is also required to protect the integrity of the program, however. When a loss occurs it is necessary to assess the damage and calculate the magnitude of the claim to be submitted. The passage of time, the effects of weather, and the decomposition of perishables will degrade the quality of the information available to quantify the loss. Failure of the adjuster to arrive on the scene in a timely manner can make the accurate assessment of loss impossible.

There are substantial grounds for concern about the ability of the FSA to adhere to these deadlines. In part it is again a matter simply of staffing levels. The FSA as it is now constituted would be hard pressed to assign as many people – particularly during key periods – to the operation of the program as do the reinsured companies. Equaling – or even approaching – the staffing levels of the private sector would require substantial augmentation of the FSA's staff.

As we explain below, the private sector is able to achieve these staffing levels economically through the creative use of part-time personnel. Most insurance agents sell other lines besides crop insurance. Most loss adjusters perform this work on a part-time basis, responding as need arises. The reinsured companies even make extensive use of temporary back-office personnel during peak periods when large volumes of policy documents must be processed. The most likely policy of the FSA in the near term, and possibly also over the long term, would be to attempt to carry out the program with smaller numbers of full-time personnel. The inevitable result would be a degradation in the timeliness of FSA's response to program demands.

There is reason for concern about the ability of FSA to meet program timelines even apart from the question of the adequacy of FSA staffing levels. A variety of mechanisms exist for assuring private-sector compliance with program deadlines. Commission-based compensation of insurance agents encourages them to pursue business aggressively and win farmers over by prompt service. The compliance arm of the RMA reviews the adherence of the reinsured companies to program deadlines, and imposes penalties when those deadlines are not met. The competition between companies for the business of farmers forces them to pay close attention to the demands of farmers for prompt and efficient service. FSA would operate free of competition, and largely free of regulatory oversight. Its status as a public agency would insulate it from many of the forces causing private companies to accelerate their business processes.

The experience of the FSA and its predecessor agencies with farm loan programs reviewed above illustrates clearly their tendency to cut corners on program requirements. Similar failure to adhere to program timelines can be expected under public delivery of crop insurance.

FSA's Technology Is Incompatible with the Needs of the Crop Insurance Industry

To deliver the product efficiently, assure compliance with program requirements, and provide the levels of service demanded by farmers, the reinsured companies rely heavily on modern information technology and customized software designed and developed specifically for this purpose. These systems are described in more detail below. The computer systems upon which the FSA relies are incompatible with the requirement of a modern insurance delivery system.

The FSA inherited a technological hodgepodge from its predecessor agencies in 1994. The former ASCS had a network located in almost 3,000 state and county offices. This system was designed and installed in the early 1970s. The software was custom designed by the agency to meet the needs of the agency. The support hub for the hardware and software is in Kansas City, Missouri. Because of the large volume of data collected and the nature of the programs for which the agency was responsible, the system was designed as a "batch operation," meaning that data were queued up overnight by the county offices and collected in batches by the central management data center in Kansas City. The FmHA system, on the other hand, was a stand-alone desktop system providing no between-offices networking capability. Data collection and automation support were centered in St. Louis, Missouri.

This collection of systems clearly lacks the capabilities needed to provide effective support to the delivery functions. Obviously, the FSA does not have the specialized software that would be required. Below we present some rough estimates of costs of building these systems. However, setting aside even the question of software, it is clear that the equipment the FSA relies upon would not be up to the task of supporting delivery. Whether it possesses the raw capacity needed to track the myriad details on hundreds of thousands of insurance policies is doubtful. It lacks the electronic communications capabilities essential for the efficient transmission and processing of

policies, claims, and payments. Also lacking are the real-time database query capabilities essential for the ability to answer questions and resolve problems encountered by farmers, agents, and loss adjusters.

Cost Savings From FSA Delivery Are Illusory

There is nothing in the available evidence to suggest that a return to public delivery would generate meaningful cost savings. To the contrary, a return to public delivery would impose substantial additional costs on the government, both on a one-time and an ongoing basis. Any cost savings from such a move implied by the OIG report are illusory.

Below we discuss some of the specific additional costs associated with a return to public delivery. The first two subsections focus on the transition from the present system to the system of public delivery suggested by the OIG report. The first analyzes the one-time cost of rebuilding a crop insurance delivery capability within the FSA. The second examines the added cost of maintaining access to crop insurance by farmers during the transition period. Together these sections conclude that the one-time cost of returning to public delivery would amount to many hundreds of millions of dollars. The third subsection reviews available evidence on the relative efficiency of public and private delivery on an ongoing basis. It concludes that on an ongoing basis, ignoring entirely the substantial costs associated with the transition, public delivery is likely to be more expensive and place greater burdens on the public treasury than the present system.

Cost of Re-equipping FSA To Deliver Crop Insurance

The current FSA has had little experience with the crop insurance delivery business, and has not sold or serviced CAT policies for two years. It lacks the personnel, organizational structure, and information systems needed to carry out this function. If a decision were made to return to public delivery, all of these capabilities would have to be rebuilt, at considerable expense. The one-time costs associated with creating within FSA even a rudimentary delivery would undoubtedly be very substantial.

Preparation of a comprehensive estimate of the magnitude of entry costs is beyond the scope of this report. Nonetheless, some sense of their magnitude can be gained from

consideration of selected elements of the entry process. In this section we focus on two such components: personnel costs and information system development. Together they total approximately \$240 million.

As the reports on FSA performance reviewed above indicate, the agency has had difficulty carrying out its present set of responsibilities in a timely manner. Nothing in these reports suggests that the FSA has much in the way of spare capacity. This fact alone indicates that if the FSA were given the task of delivering crop insurance it would have to hire new staff to carry out this function. Quite apart even from the salaries that would have to be paid to such new staff, the one-time costs associated with their hiring can be very substantial. New staff would have to be added in a number of areas, including sales, training, loss adjustment, information systems, and management. We estimate the one-time cost of hiring these personnel at \$44 million.

The reinsured companies currently rely upon a sales force of approximately 15,000 insurance agents, a number that exceeds by a large margin the total number of county office employees working currently for the FSA. As noted above, most of these agents sell crop insurance on a part-time basis, and sell other lines of insurance during the periods outside of the crop insurance selling seasons. As an initial approximation, one can take 15,000 as the number of agents needed to provide adequate coverage of the nation's farmers. It is unlikely, however, that the FSA would actually increase its head count by this number, despite that fact that reaching current participation levels has required this level of agent coverage. A more realistic estimate has the agency adding the equivalent of perhaps two FTEs per county office, for a total increase of approximately 5,000 employees.⁵⁷

Very little hard information is available on what it costs the federal government in general or the FSA in particular to hire a new employee. In the private sector, however, estimates place

⁵⁷ The concentrated seasonal nature of the selling process would create pressures for FSA to divert staff from other assignments in order to make more staff available to farmers during sales periods. In limiting our estimate of the number of required new hires to 5,000, we have assumed that the staff assigned to crop insurance delivery would carry out other assignments during the intervals between selling seasons. We have not examined FSA's other responsibilities in detail to determine how readily they would lend themselves to this sharing of staff. Without such sharing, the number of new staff FSA would have to hire in order to carry out the delivery function might well exceed our estimate.

this cost in the neighborhood of 15 percent of an employee's annual salary. If we use this figure and assume an average salary for new hires of \$40,000 per year, we arrive at a cost per new hire of \$6,000. Based on this estimate, adding 5,000 new employees to handle the delivery function would cost about \$30 million.

Of course, the new staff the FSA would have to add in order to rebuild its delivery capability would extend well beyond the sales function. Some of the other areas in which new staff would be required would include loss adjustment, training, information systems, and program management.

It is difficult to envision the FSA carrying out the loss adjustment function in a way dramatically different from that currently used by the reinsured companies. The random and episodic nature of crop losses and the resulting demands for loss adjustment argue strongly for the use of part-time and on-call personnel. It is likely, in fact, that under public delivery the FSA would contract with many of the same loss adjusters currently used by the private sector. The total number of adjusters employed by the reinsured companies is difficult to determine. As part of the preparation of this report we interviewed officials from two companies, each of which accounted for 20 to 25 percent of the total crop insurance market. Each company maintained contractual relationships with approximately 1,000 loss adjusters. The extent of overlap between these two sets of adjusters is hard to estimate, although both companies indicated that they tend to work with agents committed to providing them with priority service. It appears reasonable to assume that there are between 3,000 and 4,000 crop insurance loss adjusters nationwide. Employing such personnel on a part-time or temporary basis is likely to be less expensive than hiring them full-time. If we assume conservatively that such employees can be hired at a quarter the cost of a full-time employee, we arrive at an estimate of about \$5.3 million for the cost of building a loss adjustment staff.

In addition to the adjusters themselves, the FSA would have to hire supervisors to oversee the adjustment process. One company we met with that accounted for approximately one-fifth of the overall crop insurance market employed approximately 60 such supervisors. If FSA achieved the same efficiency in management – a doubtful proposition, as we discuss below – it would

require 300 such supervisors to serve the entire market. Their hiring could cost an additional \$2.3 million.

As part of our field research, we met with two major writers of crop insurance who have devoted substantial resources to the training of sales agents and loss adjusters. The involvement of many individuals on a rotating or part-time basis made it difficult to estimate the total number of staff hours devoted to this function. In addition, the long involvement of both companies in the program provided them with a substantial advantage in the form of existing training materials that could be modified incrementally to accommodate program changes and new products. Were FSA to take over the delivery function it would either have to develop a new set of training materials, or else simply dispense with the training function and accept the loss in quality of service and program integrity that this would entail. We have not estimated the cost of developing a new set of training materials or of hiring the staff needed to carry out an effective training program, but we believe it to be substantial.

Each of the two companies we met with had a staff of approximately 50 involved in information systems development and maintenance. We can estimate that there are likely to be 300 to 400 such people employed industrywide. A single organization such as FSA delivering crop insurance across the country might be able to realize some economies of scale in carrying out this function, and get by with perhaps 200 such personnel. We estimate the cost of hiring such personnel to be about \$1.5 million.⁵⁸

The reinsured companies also employ a large number of people involved in back-office accounting and processing functions. The FSA is having difficulty keeping up with its current workload, and so would have to hire new personnel to carry out these functions. Based upon interviews with reinsured companies, we estimate that if the FSA were to match current efficiency levels, another 700 to 800 staff would be require to perform these functions. Hiring them would cost approximately another \$3.4 million.⁵⁹

⁵⁸ This estimate is based on an assumed salary of \$50,000 and a cost per hire of 15 percent of their annual salary.

⁵⁹ Based on an assumed salary of \$30,000 and a hiring cost of 15 percent of their annual salary.

Finally, to supervise and oversee the staff involved in crop insurance delivery, the FSA would have to hire some number of management personnel. The two companies with which we met each currently rely upon a system of divisional offices to oversee staff in the field. These offices cover the entire country while at the same time efficiently concentrating resources on the major agricultural production areas. It is reasonable to expect that rather than developing a management structure optimized around the requirements of the crop insurance program, the FSA would instead add new personnel to its present system of state offices. We anticipate the hiring of three to four new management personnel per state office. Their hiring would cost perhaps another \$1.3 million.⁶⁰

Exhibit 9 summarizes our estimates of the costs of hiring the new staff that would be needed were the FSA to take over responsibility for delivery of crop insurance. These come to a total of approximately \$44 million.

Far more significant than hiring costs would be the cost of developing the information systems needed to support delivery of crop insurance. Each of the companies we interviewed emphasized the complexity of the systems they rely upon, and the costs they have incurred over many years to build them. Their complexity is directly attributable to the complex nature of the crop insurance program. Multiple peril crop insurance is not one product, but a whole array of products, with provisions and terms that vary by crop, location, and season. Numerous regulatory requirements must be met. Program provisions change frequently. Often changes must be made on short notice. All of these facts make the task of designing and maintaining the supporting information systems for the program difficult.

Some idea as to the complexity of these systems can be gained from a simple listing of some of the specific computer systems relied upon by one of the companies with which we met:

- **Policy Processing.** This system maintains the basic database of active insurance policies. It contains information from application forms, tracks policy status, and handles policy changes and renewals.

⁶⁰ Based on an assumed salary of \$50,000 and a hiring cost of 15 percent of their annual salary.

- **Policy Issuance.** An entire computer system is devoted to maintaining policy language and producing printouts of the correct language for each policyholder.
- **Cash Processing.** This system handles generation of bills, recording of payments, production of multiple notices in cases of nonpayment, and other payment and billing related functions.
- **Agent Accounting.** This system handles financial interactions with agents, including the payment of commissions.
- **Claims Processing.** This very complex system handles the processing of notices of loss, loss adjustment results, claims payments, and related matters.
- **Management Information Systems.** Numerous reports are generated by these systems to support the monitoring and management of the business.

Although these systems may in some cases sound like simple database applications, they are far more complex in their operation. To assure compliance with program regulations and requirements, they incorporate extensive edit and validation checks that have been developed, tested, and refined over the space of many years. Replicating these checks de novo would be extremely difficult. Failing to replicate them would seriously compromise program integrity.

Because these systems were developed and refined incrementally over many years, the reinsured companies with which we met were not able to document their full development costs. Both believed, however, that any attempt to develop comparable systems from scratch would be extremely expensive. Independently, each company estimated the cost at well over \$100 million.

We confirmed these rough estimates through conversations with staff at an information systems company experienced in the development of such systems.⁵⁹ Cost estimates obtained in this way are presented in Exhibit 10. They indicate that an expenditure of approximately \$200 million would be needed to equip the FSA with the information systems needed to support reentry.

⁵⁹ These estimates were prepared with the assistance of Doug Houseman of Cap Gemini.

Cost of Maintaining Access to Crop Insurance During the Transition Period

A decision to turn delivery of crop insurance over to the FSA would require a very significant expenditure to maintain private-sector delivery during the transition period. The FSA will not simply be able to announce one day that it is ready to start selling crop insurance to farmers. Realistically, a considerable period of time – perhaps measured in years – may be needed before FSA would have in place the staff and training capability and information systems needed to support delivery without massive disruption to the nation’s agricultural risk management system. To avoid the creation of a dangerous gap in coverage, the FSA would have to maintain private-sector delivery during the delivery period. Accomplishing this would require extraordinary expenditures over and above those associated with the program’s ongoing operation.

Announcement of a decision to turn crop insurance delivery over to the FSA would sound the death knell for the jobs of thousands of private sector employees currently responsible for carrying out this function. All would know that within a short period of time each would have to find another way to earn a living. One can easily anticipate that rather than waiting until the last day, many if not most employees would immediately begin the search for another livelihood. The most aggressive, energetic, entrepreneurial, and talented among them would likely be among the first to move on to other careers. Among those who remained, job performance would be likely to deteriorate, both because of the distractions of the job search and because in an end-game situation of this nature the penalties the private companies would be able to impose for poor performance would be limited. The net result of all of these factors would be a serious degradation in organizational performance, to the point where the ability of the reinsured companies effectively to discharge their responsibilities could be jeopardized.

Maintenance of employee commitment and effectiveness throughout this transition period would require substantial bonus payments. Withholding such payments until the conclusion of the transition period would be necessary to establish strong incentives for the maintenance of commitment and work effort. The prospect of receiving severance payments sufficient to carry employees securely through the search for new careers would likely be a precondition of their deferring the job search and staying with the program through the day of its demise.

Although the amount of bonus that would have to be paid in order to keep employees on the job is hard to calculate precisely, it is clear that it would have to be perceived as substantial. A reasonable estimate is that this bonus would have to equal a year's salary. Based upon the salary bills of the companies we visited and the shares of total MPCl premiums they accounted for, we place the cost of this one-time bonus at \$65 million.

A decision to end private delivery could be expected to affect the willingness of the reinsured companies to share in the risk of the program during a transition period. Under current arrangements a company that experiences a year of losses can expect in subsequent years to cover that loss from underwriting gains. Experience indicates that the program's biggest losses tend to be concentrated in isolated years in which widespread disasters occur. Losses experienced during a transition to public delivery, however, would not be subject to this kind of risk pooling, and so could not be covered in this way. Extra compensation would be required to induce the reinsured companies to bear this increased risk. This is especially likely to be the case given that the companies have experienced now a number of successive favorable years and are therefore, in the minds of many, due for a major loss year.

An alternative that might well be demanded by the private companies and implemented during a transition to public delivery would be to end risk sharing and instead simply compensate companies for their delivery expenses. However, any such effort to shift the basis for compensating the private companies participating in the program would have to make up for the current gap between companies' actual delivery expenses, and the reimbursement offered for them by the current SRA. In its companion study on behalf of NCIS, PricewaterhouseCoopers has placed the size of this gap in 1998 at \$100 million.⁶⁰ Additional expenditures of this magnitude might be required for each year of the transition period. Such a transition period could be expected to last a minimum of two years.

It is not clear that expenditures even of this magnitude would be sufficient to induce private companies to maintain their participation in the program through the period of transition to public

⁶⁰ Federal Crop Insurance Program Profitability and Effectiveness Analysis: 1999 Update, PricewaterhouseCoopers, May 1999, p.4.

delivery. These companies, like their employees, would have to consider what they would or could do once their involvement in the program ended. At that time they would be forced either to shut down or to turn to other lines of business. In the current fast-paced and competitive business climate one could anticipate that the companies making this transition most successfully would be the ones who started the earliest. It is likely, therefore, that companies would take steps to get out of the crop insurance business as soon as they knew that it no longer held a future for them.

The companies that we met confirmed this point very clearly. Each stated independently that they owed it to their shareholders to salvage as much of the value of their business as they could, and that to be effective this salvage effort would have to involve action either to liquidate the business or to enter some new market.

To avoid the creation of such a crisis upon the announcement of a decision to return to public delivery, the government would have to provide extraordinary incentives to the reinsured companies to compensate them for staying in what for them would be a dying business. In economic terms, this compensation would have to equal or exceed what they could earn by liquidating their businesses, or by turning promptly to other more viable lines of business. In postponing these actions the private companies would clearly be forgoing significant opportunities to extract value for their shareholders, and they would have to be compensated for this loss. Although we have not calculated the magnitudes of the incentives that would have to be provided, it is clear that they are substantial. They would clearly have to exceed – and by a very large margin – the payments the companies would expect to earn under normal conditions during the two or three years it would take to make the transition to public delivery.

Even assuming a relatively rapid two-year transition period, and ignoring the additional expenditures that would be necessary to maintain the commitment of the reinsured companies to what for them would become a dying business, we arrive at an estimate of the cost of maintaining private sector involvement of \$265 million. This is, of course, a considerable sum of money.

Relative Efficiency of Public and Private Delivery

The most amazing fact about OIG's recommendation that USDA consider a return to public delivery is that all of the available evidence indicates that public delivery would be more expensive than private delivery, rather than less.

To support its argument that public delivery may be more efficient, the OIG report cites two sets of facts. In the first it compares the approximately \$759 million paid in 1998 to the reinsured companies to cover their delivery and administrative expenses with the \$721 million budget of the FSA.⁶² In the second, it cites the findings of the 1997 GAO report regarding the comparative costs of public and private CAT delivery.⁶³

The first set of facts, even if true, bear no logical relationship to the point the OIG is attempting to make. The figure of \$721 million represents the cost the FSA incurs in carrying out its present set of responsibilities. It has nothing to do with the cost the FSA would incur in carrying out the very different and in many ways more demanding responsibilities associated with delivery of crop insurance. By comparing the \$759 million paid to the reinsured companies with the \$721 million FSA budget, the report implies that the latter figure somehow represents the cost of public delivery. This is not true, and the comparison itself is seriously misleading.

Although the 1997 GAO report does assert that public delivery of CAT is less expensive than private delivery, the flaws in this analysis were amply discussed at the time that report was issued. The GAO arrived at its conclusion by including as part of the cost of private delivery underwriting gains earned by the reinsured companies. Obviously, the government would have been better off in that year if it had retained the underwriting gains reported by the GAO rather than allowing them to be retained by the private sector. The same logic works in reverse, however, during years of loss. In either case, however, underwriting gains or losses experienced

⁶¹ Federal Crop Insurance Program Profitability and Effectiveness Analysis: 1999 Update, PricewaterhouseCoopers, May 1999, p. 4.

⁶² OIG Report, p.12.

⁶³ *Crop Insurance: Opportunities Exist to Reduce Government Costs for Private Sector Delivery*, GAO/RECED-97-70, 1997.

by the government have to do with how risk is shared between the public and private sectors, rather than how crop insurance is delivered to farmers. To assess the relative efficiency of the two modes of delivery, one needs to compare delivery costs in isolation.

The figures reported in the 1997 GAO report indicated that on a per-policy basis public delivery of CAT was actually more expensive than private delivery. Moreover, as noted by Price Waterhouse in its 1997 commentary on the GAO report, the CAT policies sold by the private sector covered substantially greater risks than those sold by the public sector.⁶⁴ Hence, on a per-dollar-of-premium basis the relative efficiency of private delivery is even greater. As a percentage of premiums paid, private-sector delivery costs were 15.4 percent versus 22.6 percent for the public sector.⁶⁵

A further issue that is hard to quantify, but nonetheless significant and worthy of consideration in this context, is the possible effect that a move to public delivery might have on the program's loss ratio. A tendency on the part of FSA to loosen underwriting and loss adjustment standards in order to offer more "help" to farmers, or a willingness on the part of FSA to respond favorably to requests by elected officials for special assistance to constituents, could have significant effects on payments under the program. Under public delivery the program could well show fewer underwriting gains and larger and more frequent losses than it does currently under private delivery.

CONCLUSION

For nearly 20 years a unique public/private partnership has provided multiple peril crop insurance to the nation's farmers. The trend throughout this period has been for the private sector to assume an increasingly significant role in the partnership. As the private sector's role has expanded, so has the ability of the program to meet the goals set for it by Congress. Implementation of the OIG's recommendations would reverse this trend, establishing a fundamentally new direction for the program. That direction – a return to public delivery – would burden the federal Treasury with

⁶⁴ Federal Crop Insurance Program Profitability and Effectiveness Analysis, Price Waterhouse LLP, April 1997.

⁶⁵ *Ibid.*, 42.

huge start-up costs and ongoing delivery expenses, would degrade service to producers, and would compromise program integrity. Thus, we conclude our report by exploring the rationale for private-sector involvement in the program and the contribution of the reinsured companies to the public/private partnership upon which the program is based.

OIG's Criticisms

Deprivatizing the crop insurance program in the manner proposed by the OIG would be a momentous reversal of the evolution of the program, and is not warranted by the criticism or evidence the OIG provides in its report.

The report never directly addresses the question of whether private insurance companies should be involved in the crop insurance program or, if involved, what their role should be. However, the OIG is sharply critical of many aspects of that involvement. It argues that the private companies “have little reason to effectively monitor risky policyholders, little reason to deny claims of questionable losses, and no cause to find fault with their own practices.”⁶⁶ It claims that the companies “pressure loss adjusters to rubber-stamp policyholders’ loss claims.”⁶⁷ A persistent theme of the report is that the companies have inappropriately enriched themselves at the expense of the government and of policyholders. In connection with the first of these issues it discusses, the report asserts both that “inequitable risk-sharing with reinsured companies has cost the government millions of dollars,” and that “company revenue (has) increased at the expense of good program management.”⁶⁸ OIG recommends that “RMA should evaluate options available for a more efficient program delivery system, including the possibility of a Government-administered delivery system.”⁶⁹

As many of the parties commenting on the OIG report have clearly established, the factual underpinnings of many of these arguments and assertions range from thin to nonexistent. By no

⁶⁶ Report to the Secretary on Federal Crop Insurance Reform, U.S. Department of Agriculture/Office of Inspector General, Revised April 19, 1999, No. 05801-2-At, p. 1.

⁶⁷ *Ibid.*, 2.

⁶⁸ *Ibid.*, 9.

⁶⁹ *Ibid.*, 6.

means do we concede the accuracy of its statements about the cost, efficiency, competency, or compliance of the private insurance companies participating in the program. In addition, however, we do not believe that OIG has even asked the right question. Its report implies that the only reason for involving private insurance companies in the program is to reap possible efficiencies in delivery, and that if private delivery were to turn out to be very slightly more expensive than public delivery, this fact by itself would be sufficient reason to take delivery out of the hands of the private sector.

Even if private delivery were more expensive – and that is not the case – any savings made possible through deprivatization would have to be weighed against the adverse effects that such a move would have on access by producers, participation, quality of service, speed of response, adherence to objective standards for loss adjustment and claims processing, and many other factors.

Deprivatizing the crop insurance program in this way would be a momentous step to take, and one that would reverse twenty years of policy evolution. It is not a step that ought to be taken lightly or for small reasons. Hence, it is very important for all of the participants in this debate to understand the full ramifications of such a decision. For the past 20 years, private insurance companies have played a crucial role in the crop insurance program. Without their involvement, it is doubtful the program would ever have been able to achieve important goals set for it by Congress.

In order to place the criticisms and recommendations of the OIG report in perspective, we discuss below what a completely private crop insurance system might look like, and then consider how the system might work if it were solely in the hands of the government. In this way we illustrate the implications of dissolving the public/private partnership upon which the crop insurance program is based.

Nature of the Program Under Purely Private Provision

A purely private MPCl program designed and delivered by private insurance companies without government assistance or control would look dramatically different from the program that exists today. In the absence of public support, the program would have to charge higher rates than those currently offered and the concept of universal coverage would be eliminated. Some of the most productive agricultural land in the country would be rendered too high-risk for individual farmers because of the potential for catastrophic disaster due to drought or flood. Financial institutions would be reluctant to finance diversification of farming operations for fear of the unknown risk that the farmer would incur on new or untested cropping patterns. Global market demand could go unfulfilled because of artificial shortages of some crops while at the same time there is over production of other traditional crops. Spreading agricultural risk beyond the farmgate and beyond the agricultural community has been a key to success of the US crop insurance program. Multi-peril crop coverage is almost unheard of outside of the United States and Canada. A good deal of this success over the last twenty years can be attributed to the public/private partnership of risk sharing.

One of the factors that would shape a purely private crop insurance program is the unique nature of the risks covered by MPCl. The losses experienced in the agricultural sector tend to occur in connection with large-scale, widespread, and randomly occurring natural disasters. The widespread drought that occurred in 1988 and the flooding of 1993 exemplify this fact. The tendency of crop losses to occur in large concentrated lumps makes the traditional risk-pooling functions of private insurance companies more difficult. In other property/casualty insurance lines such as automobile or fire, losses tend to be localized and to occur independently of one another. Across a large number of policies these risks tend to average out, yielding a relatively predictable pattern of losses and claims.

To some extent, a similar averaging process occurs in connection with MPCl. Localized losses do occur that are limited to specific crops or geographic areas. However, the fact that agriculture is subject to random and widespread disasters creates an element of risk that requires pooling across time periods. Private companies offering coverage against these risks would have to build up surpluses during the good years in order to be able to cover and survive very large losses during random disaster years. This is not necessarily beyond their capabilities; however, it

is a harder task than that faced in many other insurance lines. A danger would always remain that during times of disaster the claims that are filed may exceed the financial capacity of one or more insurance carriers, forcing them into insolvency and denying farmers the protection they deserve. Companies seeking to avoid this fate would have to be cautious about the risks they were willing to assume, and the rate they were willing to offer in exchange for doing so.

It is worth noting in this connection that hail insurance, which is a purely private product, covers a very different pattern of risk. Hail losses tend to be very localized. Widespread losses caused by hail are virtually unheard of. In this setting the risk pooling and management tools that have long been available to the private sector adequately support a purely private insurance product requiring no governmental support.

Without public support, a purely private crop insurance program would be forced to charge higher rates than those offered by the present system. These rates would place more of a burden on farmers purchasing coverage. Some farmers might decide because of the higher cost to forego coverage altogether, or to purchase less protection than they otherwise might.

The existence of high-risk agricultural production areas that are subject to large and frequent losses creates further barriers to the development of a purely private MPCl system. Throughout the history of the crop insurance program, there have been areas that have tended to run chronic losses. One might argue that this is a pricing problem, and reflects simply a failure to price this coverage on an actuarially sound basis. And, to an extent, one would be correct. However, experience suggests that there are production areas where, if one were to price that coverage on a fully actuarially sound basis without public subsidy, the resulting premiums would be so high that farmers would refuse to purchase it.⁷⁰ Most knowledgeable observers believe that under a purely private crop insurance system producers in such areas would be priced out of the

⁷⁰ Whether farmers in such regions would in fact be able to survive repeated disaster without insurance or other disaster assistance is not clear. A hard-nosed analysis might question whether such operations were economically viable in the sense of covering their costs and providing acceptable returns to their operators. We are not able to comment on this question. However, we note that over a period of many years the USDA and Congress have sought to provide assistance to farmers in high-risk areas and keep them in business. These actions reflect a policy judgment that farmers in high-risk areas should be supported and provided with the tools necessary to manage their production risk.

market. They would be denied access to the disaster protection and risk management tools that Congress sought to provide to all producers.

One of the reasons producers in high-risk areas would be unwilling to purchase unsubsidized MPCI is their recognition that if a disaster were to occur, they would have a good chance of successfully petitioning Congress for assistance. The historical record indicates clearly how difficult it is politically for Congress to turn down requests for assistance and relief from disaster-stricken constituents. As frequent past beneficiaries of ad hoc disaster relief appropriations, farmers are well aware of this historical record. In calculating the expected benefits of purchasing MPCI coverage, one of the factors farmers take into account is their likelihood of receiving disaster assistance even in the absence of insurance coverage. This factor weighs most heavily in the purchase decisions of producers in high-risk areas, but to some extent it influences the economic calculus of all prospective MPCI purchasers. It reduces their willingness to pay for insurance coverage and reduces the size and extent of coverage that a purely private crop insurance program would be able to achieve.

Under a purely private system companies would be under no obligation to sell insurance to all who desire it. Farmers with unfavorable loss histories could expect to be denied coverage. While the desirability of such a change from a social and economic standpoint might be debatable, there is no doubt that some farmers who currently enjoy insurance protection might be denied it under a purely private system.

For all of these reasons, a purely private crop insurance program would be dramatically different from the current program. Either the coverage offered by such a program would be more limited in terms of the perils against which protection was offered, and the degree of protection that was available, or premiums would increase significantly. The crops and geographic areas covered by it would probably be much more limited than is the case under the current mixed public/private system. Farmers with unacceptable loss histories would likely be excluded.

The more limited and costly program that would be expected to emerge under a purely private system of crop insurance would necessarily leave many farmers without protection against the effects of natural disasters and crop losses. Under such a system, Congress could be expected to respond to the needs of uninsured farmers with increased appropriations of ad hoc

disaster assistance. Under a purely private system of crop insurance, such appropriations could be expected to be substantially larger than they have been under the current public/private system.

Nature of the Program Under Purely Public Provision

The extent of participation in the crop insurance program by eligible farmers has been a significant concern over most of the program's history. In 1980 Congress established a goal for the program of enrolling at least 50 percent of the acreage in production. Nearly two decades were to pass, however, before this goal was achieved. The existence during most of this period of large numbers of farmers and large volumes of agricultural production without insurance coverage severely limited the ability of the crop insurance program to fulfil its congressionally mandated role of serving as a major part of the safety net protecting the nation's farmers against the effects of natural disasters, weather, and other types of crop losses.

It was not until the task of delivering crop insurance was turned over to private companies that Congress's long-held goal of universal participation in the crop insurance program began to seem achievable. The contribution of private companies and private insurance agents in this area has been critical. It is highly unlikely that a purely public crop insurance system would be able to achieve the level of participation that now characterizes the program. The reasons why the private sector has been more successful in this area are not difficult to identify.

Crop insurance has to be sold to farmers. Unlike many other federally sponsored agricultural programs, the crop insurance program does not simply hand out payments. Instead, it requires up-front commitments by farmers, and payments even in years free of losses. In return it offers a measure of protection against perils unpleasant to contemplate and often seemingly remote. These facts, in combination with the realities of human nature, make crop insurance a product that is not often sought out. Enrollment is an active process that requires agents to seek out farmers and persuade them of the wisdom of purchasing protection. Achieving high levels of enrollment requires aggressive action by highly motivated agents.

It is for this reason that commissions have traditionally constituted a large portion of the compensation of insurance agents selling retail lines. Commission-based compensation systems

reward performance and serve as highly-effective tools for motivating agents to get out of their offices and to seek out customers. Commission-based compensation systems are well known and widely accepted in the private sector. They are virtually unheard of in the civil service. It would be extremely difficult, if not impossible, to place public-sector employees on commission. It is very unlikely that highly effective sales personnel would be attracted to the public sector, since they would likely find the private-sector sales environment both more familiar and more lucrative. For all of these reasons, it is probable that under a purely public system of crop insurance the sales process would be less aggressive and less effective, with predictable implications for participation levels. The historical record bears out these conclusions.

The low participation levels likely to characterize a purely public crop insurance program would limit its ability not only to protect farmers from the economic effect of crop losses, but also to support and promote the availability of commercial farm credit. The ability of crop insurance to assure a revenue stream even in the face of bad weather or other natural disasters plays a part in lenders' decisions to make credit available to farmers. A return to the participation levels that characterized the period prior to significant private-sector involvement could adversely affect the willingness and ability of private lenders to meet the credit needs of farmers.

By its nature, the operations of a purely public crop insurance program will be more subject to political influence and intervention than a private program or than the current mixed public/private program. This is to be expected. One of the motivations for placing an activity within the public sector is to assure that it is carried out in a way consistent with public policy objectives.

Susceptibility to political influence is not necessarily a bad thing. In our system of government the will of the people is expressed through our elected officials, and we generally expect and want them to have a say in what the government does. In evaluating the likely effects of increased political influence over the crop insurance program, however, one must consider the goals of the program, the nature of the political interventions that are likely to occur, and the ends to which they are likely to be directed.

A principal rationale for substituting the crop insurance program for the traditional ad hoc approaches to the problem of providing disaster assistance was to assure that assistance would be delivered in a systematic and equitable way according to sensibly predefined rules. This

decision represented an implicit criticism of the way in which assistance had previously been delivered. In the past, individual congressional representatives would be petitioned by individual constituents or groups of constituents, and the representative would then attempt to help the petitioner by direct action. The risk under a purely public system is that legislators would likely see the program as a way of meeting constituent service goals and would use it to that end. One could anticipate that under a purely public system individual congressmen would seek to persuade those individuals charged with running the system to bend the rules in response to specific constituent problems and requests. However justified those individual requests for assistance might be, the overall effect of repeated efforts to side-step the rules to respond to such requests must be to undermine the integrity of the program. In the end, the program could take on many of the characteristics of the ad hoc system it was intended to replace.

In evaluating the likely performance of a purely public system of crop insurance one must consider the historical mission and culture of the agency charged with responsibility for its operation. Organizational factors such as these will shape the way in which any entity executes a new set of responsibilities. Insulated as they are from market forces, however, public agencies are more strongly influenced by their historical missions and cultures and the perspectives which, as a result, they bring to new program responsibilities.

Since the OIG report has suggested that delivery of crop insurance by the FSA be considered, it is appropriate to examine the historic responsibilities of the FSA, and to analyze how it would be likely to shape a program carried out under its direction. As detailed above, the FSA and its predecessor agencies have been one of the principal vehicles for delivering financial assistance and income support to farmers. Its role has largely been a benevolent one of dispensing to farmers funds appropriated for this purpose by Congress. There is a substantial risk that because of this agency's historical mission it might come to view the crop insurance program as yet another way of delivering assistance and income support to farmers. Such a development would further undermine the ability of crop insurance to serve as an equitable, rule-based system for delivering assistance to victims of bad weather and natural disasters.

A loss of confidence on the part of farmers in the integrity of the crop insurance program could be expected to have unfavorable effects on participation levels. As we have discussed,

history has already conditioned farmers to turn to their elected representatives in times of disaster, and this tendency has been a major factor behind the program's traditionally low participation rates. A perception that the way to receive favorable treatment under the crop insurance program is to petition one's representative could lead farmers to cease payment of premiums and seek ad hoc assistance if and when it is needed.

Cooperative Public/Private Provision

It is clear that neither the private sector nor the public sector is capable by itself of achieving the goals set by Congress for the crop insurance program. Each contributes in a critically important way to the program's success. A partnership between the private sector and the Risk Management Agency is essential.

There is no single obvious model for how to structure such a relationship. The current program has evolved substantially over time as the reinsured companies, the federal government, and Congress have learned through experience and experimentation. It reached a major stage in its evolution under the 1998 SRA and the Research Act. Eliminating either party from this partnership at this point would strike a serious blow, damaging the program and undoing many of its achievements of the past 20 years.

Exhibit 1
Participation in the MPCl Program

<i>Year</i>	<i>Participation Rate (%)</i>	Insured Acres (000)
1980	9.6	26,272
1981	15.9	44,996
1982	15.3	42,721
1983	11.6	27,935
1984	15.5	42,668
1985	18.2	48,537
1986	19.6	48,632
1987	21.9	49,132
1988	24.5	55,541
1989	40.0	99,875
1990	40.7	101,632
1991	34.1	85,245
1992	33.8	84,416
1993	31.7	79,365
1994	37.4	93,452
1995	88.3	220,652
1996	82.0	205,093
1997	72.8	182,027
1998	72.7	181,748

Sources: GAO; U.S. Office of Management and Budget; FCIC.

1980-1988 data taken from GAO/RCED-89-211, Disaster Assistance, 9/20/89.

1989-1994 data taken from OMB, Budget of the United States Government.

1995-1998 data taken from FCIC electronic data, Summary of Business.

From 1989-98, total eligible acres are assumed to be 250 million.

[1] AEI book (FCIC)

[2] GAO: Disaster Assistance, 1989

[3] FCIC Summary of Business Report

[4] United States Office of Management & Budget: Budget of the United States Government, Appendix, 1985-1996.

Exhibit 1 Cont'd
Participation Rate in the MPCJ Program

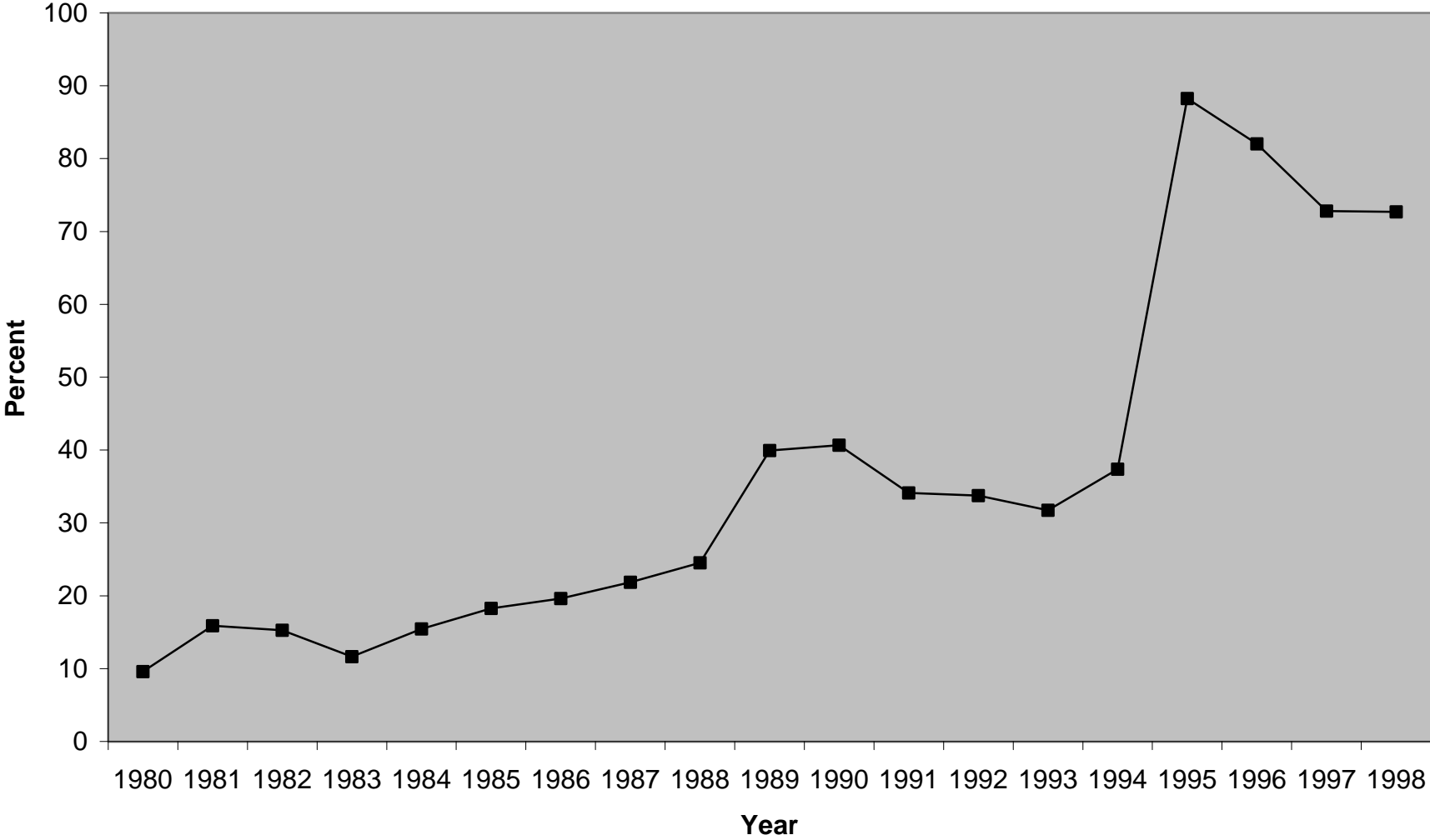


Exhibit 2
Participation in the MPCCI Program by Coverage Type

Year	Eligible Acres (000)	Participation Rate (%)		Insured Acres	
		Catastrophic	Buy-up	Catastrophic	Buy-up
1995	250,000,000	46.1%	42.2%	115,264,927	105,387,183
1996	250,000,000	35.1%	46.9%	87,800,576	117,292,796
1997	250,000,000	25.8%	47.0%	64,544,084	117,483,340
1998	250,000,000	24.6%	48.1%	61,507,171	120,241,158

Source: FCIC Summary of Business, electronic data.

Note: Total eligible acres are assumed to be 250 million.

Exhibit 3
Percentage of Retained Premiums, 1992-1998

<i>Year</i>	<i>Premium (MN Dollars)</i>		<i>Percentage of Retained Premiums</i>
	<i>Total</i>	<i>Retained</i>	
1992	694.3	465.6	67.1%
1993	702.0	434.5	61.9%
1994	918.8	534.5	58.2%
1995	1,280.6	765.8	59.8%
1996	1,622.2	1,152.5	71.0%
1997	1,687.1	1,263.2	74.9%
1998	1,875.6	1,591.4	84.8%

Source: Statement of Joseph W. Glauber, Deputy Chief Economist, U.S. Department of Agriculture, Before Committee on Agriculture, Nutrition and Forestry, U.S. Senate, March 10, 1999

Note 1: Net underwriting gains do not reflect reserve adjustments.

Note 2: 1998 Premiums are estimated as of March 3, 1999.

Exhibit 4
The Minimum Percentage of Retained Underwriting Losses in relation to Net Book Premium for a Reinsured Company

<i>Type of Fund</i>	<i>Type of Policy</i>	<i>Loss Ratio [1]</i>				
		<i>0-100%</i>	<i>101-160%</i>	<i>161-220%</i>	<i>221-500%</i>	<i>Over 500%</i>
Commercial	CAT	50.0	50.0	40.0	17.0	0.0
	Revenue	50.0	57.0	43.0	17.0	0.0
	All Other	50.0	50.0	40.0	17.0	0.0
Developmental	CAT	35.0	25.0	20.0	11.0	0.0
	Revenue	35.0	30.0	22.5	11.0	0.0
	All Other	35.0	25.0	20.0	11.0	0.0
Assigned Risk	CAT & Revenue	20.0	0.0	0.0	0.0	0.0
	All Other	20.0	5.0	4.0	2.0	0.0

Source: SRA, July 1, 1997, Section II.B.2-4 (column 1) and Sections II.C.1.a-d (columns 2-5).

[1] The loss ratio is defined as the ratio of (retained) ultimate net losses to (retained) net book premium. The ratio is aggregated by state and fund for each company.

Exhibit 5
The Percentage of Retained Underwriting Gains in relation to Net Book Premium by Fund and State for a Reinsured Company

<i>Type of Fund</i>	<i>Type of Policy</i>	<i>Loss Ratio [1]</i>		
		<i>0-49%</i>	<i>50-64%</i>	<i>65-99%</i>
Commercial	CAT	8.0	50.0	75.0
	Revenue	11.0	70.0	94.0
	All Other	11.0	70.0	94.0
Developmental	CAT	4.0	30.0	45.0
	Revenue	6.0	50.0	60.0
	All Other	6.0	50.0	60.0
Assigned Risk	CAT & Revenue	0.0	0.0	0.0
	All Other	2.0	9.0	15.0

Source: SRA, July 1, 1997, Sections II.D.1.a-c.

[1] The loss ratio is defined as the ratio of (retained) ultimate net losses to (retained) net book premium.

The ratio is aggregated by state and fund for each company.

Exhibit 6
Net Underwriting Gains, 1992-1998

Year	Fund	Premium (MN Dollars)			Net Underwriting Gain	
		Total	Ceded	Retained	Gain/Loss (MN Dollars) [1]	As a Percent of Retained Premium
1992	Assigned Risk	179.5	145.6	33.9	-0.4	-1.2%
	Developmental Risk	137.1	72.6	64.5	0.5	0.8%
	Commercial	377.7	10.5	367.2	26.1	7.1%
	Total	694.3	228.7	465.6	26.2	5.6%
1993	Assigned Risk	231.0	189.6	41.4	-0.8	-1.9%
	Developmental Risk	129.8	64.7	65.1	-4.9	-7.5%
	Commercial	341.2	13.2	328.0	-77.8	-23.7%
	Total	702.0	267.5	434.5	-83.5	-19.2%
1994	Assigned Risk	332.5	275.0	57.5	1.6	2.8%
	Developmental Risk	160.0	81.6	78.4	8.1	10.3%
	Commercial	426.3	27.7	398.6	99.0	24.8%
	Total	918.8	384.3	534.5	108.7	20.3%
1995	Assigned Risk	294.2	234.7	59.5	-0.3	-0.5%
	Developmental Risk	342.5	234.0	108.5	4.9	4.5%
	Commercial	643.9	46.1	597.8	127.3	21.3%
	Total	1,280.6	514.8	765.8	131.9	17.2%
1996	Assigned Risk	348.7	277.8	70.9	1.5	2.1%
	Developmental Risk	336.2	143.9	192.3	17.2	8.9%
	Commercial	937.3	48.0	889.3	269.2	30.3%
	Total	1,622.2	469.7	1,152.5	287.9	25.0%
1997	Assigned Risk	359.1	286.8	72.3	2.3	3.2%
	Developmental Risk	327.1	108.7	218.4	24.0	11.0%
	Commercial	788.9	23.5	765.4	244.4	31.9%
	CRC/RA/IP	212.0	4.9	207.1	81.7	39.4%
	Total	1,687.1	423.9	1,263.2	352.4	27.9%
Total 1992-1997		6,905.0	2,288.9	4,616.1	823.6	17.8%
	Estimated 1998 [2]	1,875.6	284.2	1,591.4	340.2	21.4%

Source: Statement of Joseph W. Glauber, Deputy Chief Economist, U.S. Department of Agriculture, Before Committee on Agriculture, Nutrition and Forestry, U.S. Senate, March 10, 1999

[1] Net underwriting gains do not reflect reserve adjustments.

[2] As of March 3, 1999.

Exhibit 7
MPCI Program Premiums and Indemnities
(millions of dollars)

<i>Year</i>	<i>Premiums</i>	<i>Indemnities</i>	<i>Loss Ratio</i>	<i>Cumulative Loss Ratio</i>
1939	3.4	5.6	1.6	1.6
1940	9.0	14.0	1.6	1.6
1941	11.0	19.0	1.7	1.6
1942	17.0	25.0	1.5	1.6
1943	18.0	33.0	1.8	1.7
1945	9.0	23.0	2.6	1.8
1946	35.0	63.0	1.8	1.8
1947	44.0	35.0	0.8	1.5
1948	13.0	7.0	0.5	1.4
1949	12.0	16.0	1.3	1.4
1950	14.0	13.0	0.9	1.4
1951	19.0	21.0	1.1	1.3
1952	21.0	21.0	1.0	1.3
1953	27.0	31.0	1.1	1.3
1954	23.0	28.0	1.2	1.3
1955	22.0	26.0	1.2	1.3
1956	22.0	28.0	1.3	1.3
1957	17.0	12.0	0.7	1.3
1958	18.0	5.0	0.3	1.2
1959	18.0	14.0	0.8	1.2
1960	18.0	10.0	0.6	1.2
1961	18.0	16.0	0.9	1.1
1962	22.0	24.0	1.1	1.1
1963	30.0	24.0	0.8	1.1
1964	34.0	30.0	0.9	1.1
1965	36.0	41.0	1.1	1.1
1966	37.0	25.0	0.7	1.1
1967	43.0	55.0	1.3	1.1
1968	49.0	51.0	1.0	1.1
1969	49.0	53.0	1.1	1.1
1970	44.0	42.0	1.0	1.1
1971	48.0	29.0	0.6	1.0
1972	42.0	25.0	0.6	1.0
1973	48.0	28.0	0.6	1.0
1974	54.0	63.0	1.2	1.0
1975	73.0	63.0	0.9	1.0
1976	91.0	142.0	1.6	1.0
1977	102.0	149.0	1.5	1.1
1978	94.0	47.0	0.5	1.0
1979	103.0	65.0	0.6	1.0
1980	157.0	359.0	2.3	1.1
1981	364.0	407.0	1.1	1.1
1982	596.0	517.0	0.9	1.1
1983	285.0	580.0	2.0	1.2
1984	429.0	619.0	1.4	1.2
1985	438.0	653.0	1.5	1.2
1986	379.0	612.0	1.6	1.3
1987	364.0	366.0	1.0	1.3
1988	394.0	954.0	2.4	1.3
1989	819.0	1208.0	1.5	1.4
1990	836.0	1030.0	1.2	1.3
1991	736.0	956.0	1.3	1.3
1992	758.6	922.0	1.2	1.3
1993	755.6	1651.5	2.2	1.4
1994	948.9	594.1	0.6	1.3
1995	1543.3	1567.9	1.0	1.3
1996	1839.3	1492.8	0.8	1.2
1997	1774.8	992.2	0.6	1.1
1998	1874.9	1651.8	0.9	1.1

Sources: NCIS and FCIC.

Notes: 1939-1994 data from NCIS.

1995-1998 data from FCIC Summary of Business, electronic data.

The crop insurance program was suspended for the year 1944.

Exhibit 8
MPCI Program Premiums and Indemnities by Coverage
(millions of dollars)

<i>Year</i>	<i>Total Premiums</i>		<i>Indemnities</i>		<i>Loss Ratio</i>	
	<i>Catastrophic</i>	<i>Buy-Up</i>	<i>Catastrophic</i>	<i>Buy-Up</i>	<i>Catastrophic</i>	<i>Buy-Up</i>
1995	456.0	1,087.3	167.6	1,400.3	0.37	1.29
1996	430.2	1,409.1	150.0	1,342.8	0.35	0.95
1997	349.1	1,425.7	43.6	948.6	0.13	0.67
1998	358.9	1,516.0	110.5	1,541.3	0.31	1.02

Source: FCIC Summary of Business, electronic data, 1995-1998.

Note: Buy-Up Coverage in 1997-98 included additional and limited coverage.

Exhibit 9

Cost to FSA of Hiring New Staff Needed For Crop Insurance Delivery

Function	Number of Staff	Hiring Cost[*]
Sales	5,000	\$30 million
Loss Adjustment	3,000-4000	\$5.3 million
Field Supervisors	300	\$2.3 million
Information System	200	\$1.5 million
Back Office	700-800	\$3.4 million
Management	150-200	\$1.3 million
Total	9,350-10,500	\$43.8 million

* Excludes compensation or benefits paid to or on behalf of new hires.

Exhibit 10

Estimated Cost of Developing Information Systems to Support Crop Insurance Delivery

System	Estimated Development Cost	Comments
Policy and Claims Processing	\$100 million	Based upon cost of developing a similar system for a private property and casualty insurer
Policy Issuance	\$3 million	Based upon cost of developing a similar system for a private insurer
Cash Processing	\$60-70 million	Estimate based on general systems development experience
Management Reporting	\$35-40 million	Estimate based on general systems development experience
Total	\$198-213 million	