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Audit Report

Risk Management Agency
New Crop Products
Submitted by Private Companies

Audit Report 05601-13-Te
February 2006

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250

Feb 13, 2006

REPLY TO
ATTN OF: 05601-13-Te

TO: Eldon Gould
Administrator
Risk Management Agency

ATTN: Michael Hand
Deputy Administrator for Compliance

FROM: Robert W. Young /s/
Assistant Inspector General for Audit

SUBJECT: New Crop Products Submitted by Private Companies

This report presents the results of our audit of new crop insurance plans, or products, submitted by private companies for Federal reinsurance by the Risk Management Agency (RMA). The overall objectives of our audit were to identify and evaluate the adequacy of controls over the submission, approval, and reimbursement process of section 508(h) Federal crop insurance products, and to evaluate the procedures used to monitor and review the implementation of those products.

Our review disclosed that RMA has not established written procedures to monitor and review the implementation and performance of section 508(h) products. Although Federal guidelines[1] prescribe the Federal Crop Insurance Corporation's (FCIC) and private applicants' respective roles and responsibilities—including procedures for the timing, content, and approval process for insurance products—it does not address monitoring and review procedures for FCIC Board-approved products.

We found that the prescribed procedures for the submission, approval, and reimbursement process were adequate to ensure that these products met FCIC standards; however, we noted during our review that the agency was using informal e-mails in lieu of the concurrence coversheet to track RMA's internal review process. While RMA's Product and Development Division (PDD) did not follow the agency's policies and procedures for using the coversheet, we determined that reviewers' comments were being returned to RMA PDD and that controls were adequate for monitoring the internal reviews.

[1] *Federal Register,* Vol. 66, No. 180, "General Administrative Regulations, Submission of Policies, Provisions of Policies, Rates of Premium, and Premium Reduction Plans," dated September 17, 2001.

In regard to the monitoring and reviewing of the implementation of section 508(h) products, we recommend that RMA develop and implement standardized procedures to include a timeframe for performing a contract review if deemed necessary. Additionally, we recommend RMA establish guidelines for annual evaluations performed by private companies if required in the memorandums of agreement.

BACKGROUND

The Federal Agricultural Improvement and Reform Act of 1996 authorized the formation of RMA to handle the day-to-day operations of the Federal Crop Insurance Program. This program insures producers against crop failures due to crop diseases, hurricanes, and other risks of production.

The Federal Crop Insurance Act of 1980 contained provisions for expanding crop insurance to more crops and providing coverage in most counties throughout the United States. To implement these provisions, RMA developed pilot programs for crops not previously covered by Federal crop insurance. These new programs came about as a result of requests from individual producers, producer associations, and others. Beginning with the Agriculture Risk Protection Act of 2000 (ARPA), FCIC was prohibited from conducting its own research and development for any new policies for agricultural commodities; instead, new product development must be accomplished through contracts with private companies.

In addition to new programs developed by RMA, the Food, Agriculture, Conservation, and Trade Act of 1990 added provisions to the Federal Crop Insurance Act of 1980—section 508(h)—to allow private entities to submit unsolicited proposals for insurance products to the FCIC Board of Directors for approval. Under this legislation, private companies submit new crop insurance products to the RMA Deputy Administrator of Research and Development. Within Research and Development, PDD is responsible for overseeing product development and determining if all necessary elements of the section 508(h) product submissions are included.

ARPA authorized the reimbursement of research, development, and maintenance costs for those privately developed products approved by the FCIC Board for reinsurance. Maintenance costs may be reimbursed for up to a 4-year period. At the expiration of the 4-year maintenance period, the private company responsible for the policy may charge a fee to approved insurance providers electing to sell the policy, or transfer responsibility for the policy to FCIC.

Federal guidelines[2] prescribe FCIC's and the private applicants' roles and responsibilities, including the timing, content, and approval process for policies, plans of insurance, and rates of premium submitted under section 508(h) of the act. These guidelines also establish requirements for the reimbursement of research and development costs and maintenance costs for such submissions approved by the FCIC Board. The final rule was published on August 2, 2005.[3] RMA's internal procedures for processing the submission and approval of section 508(h) insurance products require

[2] *Federal Register,* Vol. 66, No. 180, "General Administrative Regulations, Submission of Policies, Provisions of Policies, Rates of Premium, and Premium Reduction Plans," dated September 17, 2001.

[3] *Federal Register*, Vol. 70, No. 147, "General Administrative Regulations, Submission of Policies, Provisions of Policies, Rates of Premium, and Premium Reduction Plans," dated August 2, 2005

each internal area of expertise to analyze submissions and determine if they are compatible with FCIC standards and administrative procedures, as well as any applicable Federal directives, mandates, and laws.[4] Comments from each RMA area of expertise are then compiled by PDD. These procedures also govern how RMA reimburses private companies for their research, development, and maintenance costs.

The new product submission is also reviewed by an expert review panel of five independent persons with underwriting or actuarial experience. The expert review panel evaluates new insurance products for feasibility and actuarial soundness and provides a recommendation to the FCIC Board. The board then considers the internal and external reviews before making a determination on approving the product. If the FCIC Board approves the submission, the Insurance Services Division will finalize the memorandum of agreement within 30 days and complete the reinsurance agreement between FCIC and the applicant. The agreement specifies reinsurance terms, including coverage, premium, and administrative and operating subsidies. PDD then coordinates with other operational areas and the applicant to implement and maintain the approved submission. After the FCIC Board approves the products, private companies are reimbursed for their research, development, and maintenance costs.

A previous Office of Inspector General (OIG) audit disclosed several weaknesses in the review of pilot programs. OIG Audit Report 05601-12-Te, Survey of Pilot Programs, issued May 2005, disclosed that RMA needs to strengthen its monitoring of pilot programs during its evaluation periods. For the three programs reviewed, RMA experienced mounting losses through consecutive years but either made no adjustments to program provisions or made adjustments that had no perceptible effect on the losses themselves. We concluded that the monitoring process was ineffective.

OBJECTIVES

The objectives of our review were to (1) identify and evaluate the adequacy of controls over the submission, approval, and reimbursement process of section 508(h) Federal crop insurance products, and (2) evaluate the procedures used to monitor and review the implementation of these section 508(h) insurance products.

SCOPE AND METHODOLOGY

We performed fieldwork between January 2005 and October 2005 at RMA's Research and Development office in Kansas City, Missouri. We reviewed the participation data and calculated loss ratios for crop years (CY) 2003 and 2004. As of the end of CY 2004, there were 10 products approved through the section 508(h) process since the beginning of the program. One product was approved for participation in CY 2004 and another one was approved in CY 2004 for CY 2005. In addition, two of the products were turned over to FCIC in December 2002. Therefore, six products were open to participation during CY 2003, and seven products were open to participation in CY 2004. In CY 2003, the six products paid indemnities of $868,998,638 based on premiums of $1,019,762,053 for a loss ratio of 0.85. For CY 2004, the seven products had indemnities of $1,128,924,176 with premiums of $1,486,664,651 for a loss ratio of 0.76. One of the seven products

[4] *Federal Crop Insurance Directive* 17010, "Review and Approval of Private Crop Insurance Products," dated March 2000.

open to participation in CY 2004 was turned over to FCIC during March 2005.[5] Without this product, in CY 2004, the indemnities and premiums for the remaining six products approved since ARPA would have been $12,330,916 and 16,945,266, respectively, for a loss ratio of 0.73.

We selected the Livestock Gross Margin insurance product to examine RMA's product review procedures because it had a loss ratio of 2.11, the highest for CY 2004. Reimbursements are submitted at the end of each fiscal year, and we reviewed the reimbursement for Livestock Risk Protection for FY 2004 because it paid more reimbursement than any other product. To test the product submission log initiated on July 3, 2000, we judgmentally selected five products submitted from July 16, 2001, through July 8, 2004. We considered products that were approved, disapproved, and withdrawn in our selection process.

To accomplish the audit objectives, we:

- reviewed laws, regulations, policies, and procedures relating to the submission of new crop policies by private companies (section 508(h) process);
- interviewed RMA PDD officials and other operational division officials to document the submission, approval, reimbursement, monitoring, and review process and to determine the extent of any review and monitoring procedures performed;
- reviewed selected section 508(h) products' submissions and development packages to test the adequacy of controls over the submission and approval process;
- reviewed the FCIC Board's minutes;
- reviewed the most recent list of products submitted under the section 508(h) process by private companies;
- analyzed participation data, including the liabilities, premiums, indemnities, and loss ratios for CYs 2003 and 2004;
- examined copies of reviews performed to determine program performance; and
- reviewed cost reimbursement files to determine the adequacy of controls over the approval for reimbursement of research, development, and maintenance costs to the private company.

The audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States. Accordingly, the audit included such tests of program and accounting records as considered necessary to meet the audit objectives.

FINDING AND RECOMMENDATIONS

FINDING 1: Monitoring and Review Procedures Have Not Been Established

Formal policies and procedures have not been established for monitoring and reviewing the performance of section 508(h) products. This occurred because RMA officials have relied on FCIC Board reviews of product revisions and believed it was the private company's responsibility to monitor and review the section 508(h) products. As a result, vulnerabilities in privately developed products may go undetected and result in losses.

[5] This product was approved prior to the passage of ARPA.

Federal guidelines state that internal controls should be designed to ensure that monitoring occurs in the course of normal operations, is performed continually, and is well established in the agency's operations.[6] Departmental guidelines state that agency heads and heads of staff offices are responsible for establishing and maintaining a system of management controls in accordance with Government Accountability Office standards. Part of this responsibility includes ensuring timely correction of all agency-identified program and operational material deficiencies.[7]

Although we found that informal monitoring is performed for section 508(h) products, the process has not been formalized through written reports, as there are no written procedures for the performance of reviews. Internal procedures were developed for submission, approval, and reimbursement of section 508(h) products, but no procedures were developed for product review after testing.[8] As a result, we found no set procedures for how reviews are to be conducted.

The actuarial performance of the pilot programs indicates that the combined informal monitoring by RMA along with annual evaluations conducted by the private companies is reasonably effective. Without formal procedures, however, vulnerabilities have a greater chance of going undetected, particularly as more products are submitted and approved. From CYs 2000 to 2004, there were just six products approved; as more products are approved and liabilities increase, the probability of losses due to undetected policy problems will likewise increase.

RMA officials stated that they monitor section 508(h) products but do not document these monitoring procedures or perform annual reviews. Apart from RMA's informal monitoring, the FCIC Board requires private companies to submit an annual evaluation for several section 508(h) products. The board also reviews how the current section 508(h) products have performed when revisions to the current products are requested by the private companies. Revisions have been requested for every section 508(h) product.

Monitoring of Section 508(h) Products by RMA

Six of the 10 approved products were open to participation during CY 2003, while there were seven products in CY 2004. In CY 2003, the six products paid indemnities of $868,998,638 based on premiums of $1,019,762,053 for a loss ratio of 0.85. For CY 2004, the seven products had indemnities of $1,128,924,176 with premiums of $1,486,664,651, for a loss ratio of 0.76.

Even though the overall loss ratio for pilot programs was acceptable during CYs 2003 and 2004, the loss ratio for the Livestock Gross Margin product exceeded the target loss ratio for all crop programs, which was set at 1.075. Livestock Gross Margin paid indemnities of $6,869,499 based on premiums of $3,248,633, for a loss ratio of 2.11 in CY 2004. Because a loss occurred, RMA PDD wrote a review paper addressing the problems that contributed to the high loss ratio and worked with the private company that developed the product to make changes. Until these changes had been made, the FCIC Board suspended the product. We found that this report was the only formal monitoring review conducted of approved section 508(h) products during CYs 2003 and 2004.

[6] Government Accountability Office's *Standards for Internal Control in the Federal Government*, Monitoring Section, dated November 1999.
[7] *Departmental Manual* 1110-2, *USDA Management Control Manual*, chapter 1, section 4, "General Policies and Responsibilities," dated November 29, 2002.
[8] *Federal Crop Insurance Directive* 17010, "Review and Approval of Private Crop Insurance Products," dated March 2000.

Annual Evaluations Submitted to the FCIC Board of Directors

Four of the 10 section 508(h) products developed have requirements in the memorandum of agreement for the private company to provide annual evaluations of the product to the FCIC Board. For example, the memorandum of agreement for Livestock Gross Margin requires the private company to submit an annual program evaluation to FCIC by September 1 of each year. However, no guidance is given to the private company describing what elements the evaluation is supposed to cover and what information the evaluation report should include. After the evaluations are received, they are reviewed by RMA PDD and then forwarded to the FCIC Board. We found that the annual evaluation performed for Livestock Gross Margin was a summary of the performance data for the year, including any proposed changes submitted to the Board.

In addition to annual evaluations required in the memorandums of agreement, RMA officials stated that contract reviews[9] will be performed for section 508(h) products that are new concepts. If a section 508(h) product is an additional coverage component to an existing product, then it may not be reviewed. In that case, RMA will make a decision if it is cost beneficial to perform a review, and the decision will be made on a case-by-case basis.

Contract reviews have been performed for 2 of the 10 section 508(h) products. Crop Revenue Coverage and Revenue Assurance have been reviewed through contract evaluations, but Group Risk Income Protection has not. RMA officials explained that Crop Revenue Coverage and Revenue Assurance were new concepts and that a contract review was performed for Group Risk Plan. Because Group Risk Income Protection was essentially the same plan as Group Risk Plan except for a price component, RMA did not feel it was cost beneficial to review Group Risk Income Protection as well.

The FCIC Board has also recently authorized contract reviews for both Livestock Gross Margin and Livestock Risk Protection. Although these two products are still owned by private companies, RMA officials stated that these were new concepts they felt needed to be reviewed.

We conclude that RMA can improve its monitoring and review process by formalizing its procedures. Though section 508(h) products were monitored, that monitoring was only documented formally when a loss occurred and action was taken by the FCIC Board. Annual evaluations were performed by private companies when required by the board; however, no guidelines were given to those companies for conducting these evaluations. Contract reviews of the products were only performed if RMA believed the product was a new concept or that the review would be cost beneficial. Without more consistent, formal procedures for monitoring and reviewing section 508(h) products, vulnerabilities to the products may go undetected and result in losses.

RECOMMENDATION 1:

Develop and implement standardized procedures for monitoring and reviewing section 508(h) products to include a timeframe for performing a contract review if deemed necessary.

[9] Contract reviews are initiated by the FCIC Board after 3 to 4 years of participation data is accumulated. The reviews are performed by independent persons and entities approved by the board to conduct such reviews.

RMA RESPONSE:

We agree with the audit finding that RMA and private submitters were monitoring section 508(h) products, and the process could be more formalized. RMA has implemented procedures for monitoring and reviewing not only section 508(h) products, but all RMA products. On September 2, 2005, RMA issued the *Program Evaluation Handbook* (FCIC-22010) that provides a framework for comprehensive evaluations of insurance programs operated by FCIC. Additionally, RMA will use the Annual Pilot Program Monitoring Checklist contained in the *Program Development Handbook* (FCIC-23010) issued September 2, 2005, for annually monitoring and reviewing section 508(h) products.

OIG POSITION:

We cannot accept management decision for this recommendation. RMA's recently published *Program Evaluation Handbook* (FCIC-22010) includes procedures for comprehensive evaluations of FCIC's insurance programs, and is generally used for final program evaluations to determine if a pilot program should be continued, modified, terminated, or made permanent. As such, it does not include procedures for conducting annual evaluations. The "Annual Pilot Program Monitoring Checklist" in the *Program Development Handbook* (FCIC-23010) is used for annually evaluating pilot insurance programs. However, section 1C of this handbook states that "private submissions of new programs or plans of insurance under 508(h) of the act are not covered by this handbook." In order to reach management decision, RMA must provide specific procedures for annually evaluating private submissions under section 508(h) of the act.

RECOMMENDATION 2:

Establish guidelines for annual evaluations performed by private companies if required in the memorandums of agreement.

RMA RESPONSE:

RMA agrees with the recommendation and will require private companies to perform annual evaluations of their products using guidelines established in the *Program Evaluation Handbook* (FCIC-22010), if required per Title 7, Code of Federal Regulations, section 400.708(a)(1).

OIG POSITION:

We cannot accept management decision for this recommendation. RMA's *Program Evaluation Handbook* (FCIC-22010) requires final evaluations to determine if a pilot program should be continued, modified, terminated, or made permanent, but does not include procedures for performing the annual evaluations required of private companies. The *Program Development Handbook* (FCIC-23010) provides procedures for annually evaluating pilot programs developed through FCIC, but not for evaluating private submissions under 508(h) of the act. Although the agreement between private companies and FCIC (as specified in Title 7, Code of Federal Regulations, section 400.708(a)(1)) may require private companies to evaluate their products annually, RMA has not provided companies with guidelines for performing these evaluations. In

order to reach management decision, RMA must provide the specific guidelines it will issue to private companies when they are required to perform annual evaluations.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned and the timeframes for implementation for those recommendations for which a management decision has not yet been reached. Please note that the regulation requires a management decision to be reached for all recommendations within a maximum of 6 months from the date of report issuance. Final action on the management decisions should be completed within 1 year of the date of the management decisions to preclude being listed in the Department's annual Performance and Accountability Report.

We appreciate the courtesies and cooperation extended to our staff during this review.

Exhibit A – RMA Response

USDA

United States Department of Agriculture

Risk Management Agency

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Washington, DC
20250-0801

JAN 10 2006

TO: Robert W. Young
Assistant Inspector General for Audit
Office of Inspector General

FROM: Michael Hand
Audit Liaison Official

SUBJECT: Office of Inspector General (OIG) Draft Audit Report 05601-13-Te, New Crop Products Submitted by Private Companies

Outlined below is the Risk Management Agency's (RMA) response to the subject report.

RECOMMENDATION NO. 1:

Develop and implement standardized procedures for monitoring and reviewing section 508(h) products to include a timeframe for performing a contract review if deemed necessary.

RMA Response:

We agree with the audit finding that RMA and private submitters were monitoring section 508(h) products, and the process could be more formalized. RMA has implemented procedures for monitoring and reviewing not only section 508(h) products, but all RMA products. On September 2, 2005, RMA issued the Program Evaluation Handbook (FCIC-22010) that provides a framework for comprehensive evaluations of insurance programs operated by the Federal Crop Insurance Corporation (FCIC). Additionally, RMA will use the Annual Pilot Program Monitoring Checklist contained in the Program Development Handbook (FCIC-23010) issued September 2, 2005, for annually monitoring and reviewing section 508(h) products. Each of these handbooks may be obtained from the RMA public website at: www.rma.usda.gov.

RMA requests management decision for this recommendation.

RECOMMENDATION NO. 2:

Establish guidelines for annual evaluations performed by private companies if required in the Memorandum of Agreement.

RMA Response:

RMA agrees with the recommendation and will require private companies to perform annual evaluations of their products using guidelines established in FCIC 22010, if required per 7 C.F.R. 400.708(a)(1).

RMA requests management decision for this recommendation.

Should you have any questions or require additional information, please contact Alan Sneeringer at (202) 720-8813.