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Office of Inspector General
Great Plains Region

Audit Report

Risk Management Agency Financial Management Controls Over Reinsured Companies

Report No. 05801-3-KC
April 2006



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250



DATE: April 25, 2006

REPLY TO
ATTN OF: 05801-3-KC

TO: Eldon Gould
Administrator
Risk Management Agency

ATTN: Michael Hand
Deputy Administrator for Compliance

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

SUBJECT: Financial Management Controls Over Reinsured Companies

Summary

In 2002, a reinsured company¹ that was the largest participant in the Federal crop insurance program became insolvent and failed. To continue service to farmers, the regulator in the State where the company was chartered decided, with the Risk Management Agency (RMA), to take control of the company.² RMA paid the company's management costs while it finished processing premiums and settling claims. RMA has incurred about \$41.7 million in funding closeout operations. The Department of Agriculture's (USDA) Office of Inspector General (OIG) undertook a review to evaluate the agency's financial management controls for preventing and/or detecting the insolvency of reinsured companies.

We are closing our review without recommendations because we have already raised the issues that this review concluded were problematic in memoranda previously provided to RMA during its Standard Reinsurance Agreement (SRA) renegotiation process.³ We also reported our observations in Report No. 05099-109-KC, dated January 27, 2005.⁴ Further, we determined that our findings overlap those reported by the Government Accountability Office (GAO).⁵

¹ The Federal Government administers the crop insurance program through contracts with private insurance companies. Since the Government subsidizes or reinsures the companies, they are referred to as "reinsured companies" or "approved crop insurance providers" (see footnote 5).

² An agency of USDA, RMA has overall responsibility for the Federal crop insurance program, which protects participating farmers against financial losses caused by droughts, floods or other natural disasters, and also against the risk of crop price fluctuations. The agency also oversees the development of new insurance products for farmers and monitors compliance with program provisions by both farmers and insurance companies.

³ The SRA sets forth the terms and conditions under which subsidies and reinsurance on eligible crop insurance contracts will be provided.

⁴ Audit No. 05099-109-KC, "Risk Management Agency – Renegotiation of the Standard Reinsurance Agreement," dated January 27, 2005.

⁵ GAO Report No. GAO-04-517, "USDA Needs to Improve Oversight of Insurance Companies and Develop a Policy to Address Any Future Insolvencies," June 1, 2004.

OIG and GAO concluded that RMA did not identify the financial deficiencies of the failed reinsured company primarily because the agency emphasized past compliance and financial data, rather than future financial forecasts. GAO reported that the lack of relevant, contemporaneous information impaired RMA's decision-making process because the agency was forced to make decisions based on incomplete, dated, and narrowly focused information. RMA agreed to implement GAO's recommendations to strengthen the agency's oversight of reinsured companies. RMA has also addressed some, but not all, of our suggestions to strengthen the SRA.

In November 2002, the Nebraska State Department of Insurance (NSDOI) placed a reinsured company, at the time the largest participant in the crop insurance program, under State supervision. Rather than immediately liquidating the company, NSDOI decided with RMA to place the company in rehabilitation whereby the regulator takes control of a company and operates it until all remaining claims are settled and all existing policies are transferred to other companies. To ensure continued service, RMA elected to pay costs associated with closing out the company. RMA had paid about \$41.7 million in closing costs associated with the closeout that included obligations that the company could not satisfy as a result of the insolvency.

GAO has reported that the company's failure was the result of a series of management decisions that weakened the company's surplus, which made it vulnerable to collapse when widespread drought erased anticipated profits in 2002. The company's surplus also declined due to losses and other costs from mistakes made when it introduced a new crop insurance product, decided to pay above average agent commissions, and purchased a competitor's business. Additionally, GAO found the company's operating expenses were about 150 percent of its reimbursement from RMA; and the company experienced a 50 percent decline in its surplus over a 9-month period from January through September 2002. When anticipated profits did not materialize to pay expenses not covered by RMA's reimbursement, the company's surplus dropped to below the statutory minimum, which prompted NSDOI to take control.⁶

Both GAO and OIG have concluded that RMA's financial management oversight of reinsured companies was insufficient. OIG also determined that RMA's existing management controls could not promptly identify companies experiencing financial difficulties. For example, even though RMA reviewed companies' operation plans and evaluated some financial data, these procedures were not sufficient to determine the overall financial condition, especially those with rapidly deteriorating financial positions. RMA relied almost exclusively on historical financial information instead of considering whether companies would be able to meet their operating expenses for the upcoming reinsurance year.

This review supported the issues we reported to RMA when they renegotiated the SRA. We suggested that RMA could improve the SRA by requiring companies (1) to secure additional private reinsurance coverage or capitalization whenever the reinsured companies' surplus (or net worth) level drops below the required level for their book of business, (2) to provide revenue and

⁶ GAO Report No. GAO-04-517, "USDA Needs to Improve Oversight of Insurance Companies and Develop a Policy to Address Any Future Insolvencies," June 1, 2004.

expense forecasts for the forthcoming year, (3) to provide information relating to any planned acquisition of other crop insurance companies, and (4) to provide the financial roles played by parent/subsidiary companies in crop insurance operations.

At the time we concluded our fieldwork, RMA had not formalized its policies and procedures for monitoring reinsured companies. We have another audit in process that will assess the actions RMA has taken to strengthen its oversight of the financial condition of the reinsured companies.

Background

The Federal Crop Insurance Corporation (FCIC), an agency of the USDA, is a Government owned corporation that was created in 1938 to promote the national welfare by improving the economic stability of agriculture through a sound system of crop insurance. An appointed Board of Directors provides overall guidance to FCIC. In 1980, Congress enacted legislation that expanded the program and, directed that crop insurance be offered through private insurance companies (reinsured companies),⁷ which would sell, service, and share in the risk of Federal crop insurance policies. The Federal Agriculture Improvement and Reform Act of 1996 amended the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 (Public Law 103-354) by creating an independent office called RMA.

RMA is responsible for supervising FCIC and administering and overseeing programs authorized under the act. These programs include various types of insurance coverage to protect against crop and revenue losses. Multi-peril crop insurance is designed to minimize risk against crop losses due to nature, such as hail, drought, and insects, and to help protect farmers against loss of production below a predetermined yield, which is calculated using the farmer's actual production history. Catastrophic insurance provides farmers with protection from extreme crop losses. Revenue insurance, a newer crop insurance product, provides protection against losses in revenue resulting from low market prices and also against crop loss. FCIC pays a portion of farmers' premium subsidy for multi-peril and revenue insurance and the total premium for catastrophic insurance.

RMA, through FCIC, contracts with reinsured companies who then sell policies to farmers and other private insurance companies (which then also share in the associated underwriting risk under the contract or SRA). FCIC reinsures or subsidizes a portion of the premiums and pays insurance companies an administrative fee or reimbursement expense at a predetermined percentage of premiums to reimburse the companies for administrative and operating expenses associated with selling and servicing crop insurance policies, including expenses associated with adjusting claims. The level of subsidies for policyholder premiums was increased significantly under the Agricultural Risk Protection Act of 2000.

⁷ "Reinsured companies" are synonymous with "private insurance companies" and "approved crop insurance providers." The *Code of Federal Regulations* generally refers to reinsured companies as approved crop insurance providers while RMA handbooks generally refer to reinsured companies as insurance providers.

For the 2002 reinsurance year (July 1, 2001, through June 30, 2002), there were 15 approved reinsured companies. These companies wrote premiums totaling about \$3 billion, with corresponding liabilities of about \$37.3 billion. As of November 3, 2003, the associated crop indemnities totaled about \$4.1 billion.

In order to conduct business with FCIC, reinsured companies must have an SRA with FCIC. The SRA sets forth the terms and conditions under which FCIC will provide subsidies and reinsurance on eligible crop insurance contracts sold or reinsured by approved insurance providers. By regulation, every insurance company and its managing agent, if applicable, must be in good financial standing and in compliance with the laws of the State where it is domiciled and in the States where its business is written. As part of the SRA, reinsured companies must provide an annual Plan of Operations, which contains the financial information needed by RMA to determine if the planned operation is viable and should be approved.

Objectives

Our audit objectives were to (1) identify and to familiarize ourselves with RMA's management procedures in approving reinsured companies' SRAs and monitoring their financial soundness, including the existing controls for preventing and/or detecting the insolvency of reinsured companies, and (2) determine the need and areas for additional audit work. To avoid duplication of GAO's effort, our review did not assess the conditions that led to the failure of the reinsured company, the effectiveness of RMA's dissolution of the failed company, or the costs associated with conducting the company's operation to service Federal crop insurance policies after its failure.

Scope and Methodology

The audit was conducted at RMA's offices in Washington, D.C., and Kansas City, Missouri; the National Association of Insurance Commissioners (NAIC) in Kansas City, Missouri; the National Crop Insurance Services (NCIS) in Overland Park, Kansas; NSDOI in Lincoln, Nebraska; and the failed insurance company. We also interviewed the Office of the Chief Economist and Office of the General Counsel personnel in Washington, D.C., to obtain their views on issues pertaining to the failure of the reinsured company.

We conducted the audit by gaining an understanding of applicable laws, regulations, policies, procedures, manuals, and instructions governing reinsured company operations. We reviewed the guidance RMA uses to monitor companies' compliance with the Federal crop insurance program, including 7 CFR, part 400, agency guidance and the Handbook for the 2002 Reinsurance Year, and the current and recently renegotiated SRAs. This included reviews of supporting program records related to RMA's oversight of the failed company and approval of its SRA. We also interviewed officials in RMA, NAIC, NCIS, and NSDOI to obtain their views on the failure of the reinsured company and on sharing confidential business and/or regulatory information with RMA.

At the failed company, we interviewed company officials and the appointed NSDOJ Deputy Rehabilitator concerning factors that contributed to the company's failure, including the nature of pertinent financial analysis data. This included reviews of company documents and financial statements filed with NSDOJ. In addition, we assessed various analytical tools used by RMA, NAIC, and NSDOJ to evaluate the financial condition of the regulated reinsured companies.

The audit period was primarily limited to 2002 reinsurance year activities; however, older and more recent activities were reviewed to the extent deemed necessary. We conducted this review in accordance with *Government Auditing Standards*.

We appreciate the cooperation extended by your staff during this review.

Informational copies of this report have been distributed to:

Administrator, RMA	(5)
Government Accountability Office	(1)
Office of Management and Budget	(1)
Office of the Chief Financial Officer	
Director, Planning and Accountability Division	(1)