



UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Washington D.C. 20250



DATE: June 17, 1999

REPLY TO

ATTN OF: 05801-2-At

SUBJECT: Report to the Secretary on Federal Crop Insurance Reform

TO: Kenneth D. Ackerman
Administrator
Risk Management Agency

Based on our review of your April 20, 1999, response to the subject report, I concluded that the Office of Inspector General (OIG) should address some of the issues you raised. I agree that our respective agencies have enjoyed a good working relationship over the years which has resulted in significant improvements to the Federal Crop Insurance Program. It is in this very context and because OIG believes further improvements are needed, that we issued the subject report pointing out policy issues pertinent to the current debate on the future of agricultural risk management.

Officials from both agencies met on May 25, 1999, and discussed each of our perspectives on the concerns and issues raised in the subject report. We agreed that some of these issues could be possibly resolved by corrective actions that your agency is currently implementing or is proposing to implement in the future. We also agreed that the two agencies would jointly brief the U.S. Senate Committee on Agriculture, Nutrition, and Forestry and its staff and discuss each of our perspectives and possible proposals for the Committee's consideration in the following areas: underwriting gains and administrative expenses, changes in the Catastrophic Risk Protection Program, strengthening Risk Management Agency's (RMA) product development and review process, RMA's optional unit policy, and alternative delivery systems. We both share the common goal of strengthening the Federal Crop Insurance Program.

Notwithstanding our meeting and its results, I will address some of your broader concerns in this memorandum. More detailed information, which addresses each of the individual paragraphs in the body of your memorandum, is included as an attachment.

You state that the report relied on unsupported generalizations and omitted relevant information; however, the report highlights current cost data and summarizes past audit findings which require further action to resolve continuing problems. Our report was not intended to be a technical, comprehensive analysis of the crop insurance program; rather, its purpose was to precipitate discussion regarding how the current Federal Crop Insurance Program was operating. Except for a few recent developments regarding durum wheat, Crop Revenue Coverage (CRC) -Plus, etc., most of the issues had been addressed previously in prior audit reports. Regarding the flow of money to the reinsured companies and our comparison of funds received by the reinsured

companies and farmers, we simply totaled up the costs of the program as reflected in various RMA reports.

Base Period of Review

You questioned the propriety of our using information from the base period 1995 through 1998. We used this period for the following reasons:

- Reinsured companies assumed sole delivery of multiple peril crop insurance in 1995 after the last of the master marketer business was phased out in 1994.
- The Federal Crop Insurance Reform and the Department of Agriculture Reorganization Act of 1994 (1994 Act) was signed into law. The 1994 Act added the Catastrophic Risk Protection (CAT) Program to first be delivered in 1995 by the Farm Service Agency and subsequently delivered by only the reinsured companies in 1998.
- The revenue of reinsured companies increased significantly during the period 1995 through 1998. In fact, during the 4-year period, the reinsured companies received almost \$1.1 billion of the \$1.26 billion in underwriting gains received since the program began in 1981.
- Any discussion of crop insurance reform should include the most recent performance of the insurance program and the flow of revenue to the companies that deliver the programs.

You also mentioned the changes to the Standard Reinsurance Agreement (SRA) effective in 1998 and pointed out that, according to an independent analysis conducted by USDA's Office of the Chief Economist, should a 1988-type drought occur today under the new SRA, net underwriting losses for participating companies could reach \$450 million in a single year.

As we have stated, we did not study the impact of a 1988-type drought or disaster on the current standard reinsurance agreement. Rather, we reported what has most recently occurred over the last 4 years. However, we did discuss with Deputy Chief Economist Joe Glauber his \$450 million potential loss estimate if a 1988 drought or disaster were to occur today. Your use of his estimate was taken out of context in that it did not recognize his corresponding estimates for a series of large underwriting gains. Mr. Glauber's testimony on this subject actually stated "For example, had the 1988 drought occurred in 1998, it is estimated that net underwriting losses to the companies would have exceeded \$450 million. Large underwriting gains have also made it easier for reinsured companies to lay off most of their risks in the commercial reinsurance market" (Underscoring added). This is clearly illustrated in Mr. Glauber's analysis. Using his model, we determined that, if the same criteria used to calculate the \$450 million potential loss you cite for 1988 is applied to the entire period being discussed, 1981-1998 (using actual underwriting gains for 1997 and 1998), a remarkably different picture develops. Specifically, reinsureds' underwriting gains would have increased from the actual \$1.35 billion to an estimated \$4.17 billion. Underwriting gains, net of underwriting losses, would have increased from the actual \$1.26 billion to an estimated \$3.15 billion. In other words, under the provisions of the

SRA currently in effect, the reinsured companies would have received two and one-half times the net gains they actually did receive. Furthermore, Mr. Glauber's analysis shows that, during this period, reinsured companies would have experienced losses in only three years - not four, as actually occurred.

The Deputy Chief Economist based his estimate on the assumption that the reinsured companies would not have assigned policies among the various risk pools differently under the 1998 provisions to better minimize losses and maximize gains. In other words, this model is a worst case scenario, which companies could avoid, to some degree, by adjusting their book of business to the 1998 provisions.

Reinsured Companies' Share of Program Dollars Is Increasing Significantly

In your response, you raised a concern that we did not recognize that the 1998 SRA reduces revenue received by the reinsured companies. In response to your concern, we evaluated the results of the changes made to the SRA in 1998, by comparing 1996 and 1998. We chose 1996 to use in the comparison because the two years were similar, *i.e.*, the two years had comparable loss ratios and total premiums paid. (See Item No. 3 in the attachment). Our analysis showed that although the number of policies sold decreased 23 percent from 1996 to 1998, reinsured companies' administrative reimbursements decreased only about 10 percent for the same period. Moreover, even with the changes to the SRA effective for 1998, reinsured companies' underwriting gains actually increased 37 percent, from \$248 million in 1996 to \$340 million in 1998.

You also questioned our report of \$721 million for Farm Service Agency (FSA) salaries and expenses for 1998. We obtained this number directly from FSA. It is the expense for State and county office operations. It was not our intent to report the total FSA budget amount, but only that portion related to program delivery, *i.e.*, field and State office personnel and related costs. Also, in computing the costs of delivering the current insurance program, we did not include any administrative costs for RMA. Our intent was to show that there may be an opportunity to use an existing Government-delivery system which may be a more effective and economical delivery system than the one currently used. We pointed out that reinsured companies received \$759 million (\$423.2 million in administrative fees and \$335.8 million in underwriting gains) for delivering the 1998 program while budgeted FSA field and state office costs were \$721 million for delivering numerous programs including the Agricultural Marketing Transition Act, price support, conservation, emergency assistance, and loan programs. We recognize that FSA costs would increase if this option were chosen but these increases could be offset by saving all or part of the \$759 million currently being paid to reinsure companies. These savings may also make it possible to reduce farmers' premium.

OIG Conclusions Are Based On Consistent, Significant Program Deficiencies

In your response, you state that OIG's conclusions regarding loss adjustment errors, conflicts of interest, and RMA's implementation of new policy coverage without proper research are broad conclusions "based on anecdotal incidents that do not appear to pass any test of statistical significance." We believe that there is extensive evidence documented in audits that show these issues go far beyond anecdotal incidents.

Research and Development - RMA was not effectively researching new crop insurance policies before implementation. In 1996, RMA implemented the CRC Program prior to publishing regulations to establish procedures for reinsured companies to follow when submitting such programs to the Federal Crop Insurance Corporation (FCIC) board for approval. Final regulations for private products like CRC have not yet been published, even though such programs were authorized by law in 1994. The lack of regulations created confusion on how to proceed with approving the CRC program.

Also, the lack of historical data makes it impossible to measure its actuarial appropriateness. CRC was initially established as a pilot program for 1996 in two States, and was expanded the following year, still without actuarial history, and covered most of the corn, cotton, rice, grain sorghum, soybeans, and wheat produced in the U.S.

In 1997 and 1998, RMA approved insurance coverage in three separate areas of Texas with non-irrigated crop insurance coverage, when there was little likelihood that a crop could be produced without irrigation because of climatic conditions in the area. RMA paid indemnities of over \$20 million for losses associated with this coverage.

For fresh market tomatoes, RMA procedures allowed indemnities to be paid to producers who did not experience a loss in quantity or quality of production, but had suffered financial losses due to low market prices. The Office of the General Counsel opined that RMA did not have authority under this policy to make indemnity payments based solely on loss of market price.

In 1999, RMA established a guaranteed price for durum wheat under the CRC program. RMA used a simple 5-year price average that resulted in a guaranteed price substantially above the current market price. The estimated excess cost to the Government for over-estimating the guarantee is about \$74 million.

In 1994, in the California raisin program, the policy allowed producers to sell their damaged raisin crop as salvage material instead of requiring them to recondition their raisins, which substantially increases their value. We reviewed indemnities totaling \$20.9 million and estimated that \$8 million could have been saved had the policy been more restrictive to include a requirement for reconditioning.

Finally, most recently a reinsured company developed a policy called CRC Plus. The policy essentially took the RMA approved CRC policy and added 3 cents per pound for rice over and above the CRC guaranteed price of 8.5 cents per pound -- a 35 percent increase over the RMA approved amount. This policy, CRC Plus, while not approved by RMA, was added to the approved RMA policy with the knowledge of RMA officials, and caused a great deal of controversy in the farm and insurance communities when first offered, and when it was subsequently pulled back by the company. RMA needs to determine if it is appropriate to allow private sector companies to add products to RMA approved policies.

We believe that these cases show a need for a more effective review and approval process for crop insurance policies.

Conflicts of Interest - A number of our audits have identified a lack of independence in the loss adjustment process. This lack of independence includes violations such as one company where 22 of 42 sales supervisors and 22 of 51 claims supervisors had responsibility for overseeing both the sales and loss adjustment functions of the same policies. RMA had not done enough to ensure that the companies complied with these requirements. Also our audit of "Quality Control for Crop Insurance Determinations" contained four recommendations addressing conflict of interest deficiencies. RMA has not implemented these recommendations which have remained unresolved since the audit report was issued in July 1998.¹

Loss Adjustment Errors - OIG has repeatedly reported deficiencies in the loss adjustment and quality control processes. For example, five audits (1994 reinsured raisin losses in California, 1994-1996 large claims, 1995-1996 nursery programs, 1995 quality control for crop insurance determinations, and 1996 prevented plantings of insured crops) illustrate a consistent theme of significant deficiencies in the loss adjustment process and quality control operations of RMA and the reinsured companies.

In your memorandum, you indicated that the FCIC Programs have an error rate well below commercial insurance markets and that the error rate within FCIC has decreased substantially over the last 14 years. You provided us with a graph that showed the commercial error rate at 15 percent and FCIC's error rate at 30 percent in 1985 according to a General Accounting Office (GAO) report, 15 percent in 1987 per the GAO report, 10 percent in 1991 per an OIG report, and 4.8 percent in 1997 per a RMA compliance report. The error rate we reported in 1991 is based on dollars paid out in error. The rate of 4.8 percent RMA reported is based on the number of units found to be wrong with no corresponding projection of dollar loss. As such the two are not comparable and one cannot assume a downward trend in errors.

¹ Audit Report No. 05099-2-KC, RMA Quality Control for Crop Insurance Determinations, issued July 14, 1998.

Your reported error rate is also made more questionable by the methodology you employed. On page 4 of your baseline error rate review, under review methodology, RMA makes the following statement: "We accepted the APH [actual production history] data, provided by the companies, as correct for the purposes of this review only." The APH is the actual production history computed by the reinsured company for each insurable unit. RMA conducted a statistical review of the APH program from November 15, 1995, to July 15, 1996. The review determined an overall error rate of 48 percent of the policies to be in error. Therefore, since the error rate for APH is so high, and it is a component of most insurance indemnity calculations, and you accepted it at face value in your 1997 review of error rates, the reasonableness of the 4.8 percent error rate you cite is highly questionable.

The Catastrophic Risk Protection (CAT) Program's Effectiveness As a Safety Net Needs To Be Strengthened

The CAT Program has resulted in very significant underwriting gains to reinsured companies while at the same time has not served as the intended farmer safety net, particularly to the American small farmer. From 1995 to 1998, companies received about \$305 million in CAT underwriting gains or a return of about 19 percent on gross imputed premiums of about \$1.6 billion. In contrast, the companies received about 14 percent in gains on gross premiums of about \$5.4 billion for buyup policies.

Also, CAT loss ratios make it easier to meet the 1.075 loss ratio mandated by law. During the 4-year period, the CAT loss ratio was 0.30, meaning that only 30 cents was paid out for each dollar of subsidized CAT premium. On the other hand, the loss ratio for buyup policies was 0.96. Inclusion of the CAT loss experience reduces the overall loss ratio for the 4-year period to 0.81. In effect, the CAT program helps reduce the likelihood of premium increases for buyup policies to meet the targeted loss ratio because of its favorable loss history. The table below provides data on the CAT and buyup underwriting gains and actuarial performances for the 1995 - 1998 insurance period. (A more detailed table of data is included in the attachment under Item No. 12.)

Comparison of CAT Versus Buyup Policies' Underwriting Gains and Actuarial Performances for Program Years 1995-1998*

CAT Premium	\$1,594,115
CAT Indemnity	\$471,770
CAT Loss Ratio	.30
Reinsured Companies' Underwriting Gain	\$305,200
4-Year Return of Gain to CAT Premium	19%
Buy-up Premium	\$5,438,103
Buy-up Indemnity	\$5,232,956
Buy-up Loss Ratio	.96
Reinsured Companies' Underwriting Gain	\$767,500
4-Year Return of Gain to Buyup Premium	14%
Combined Loss Ratio	.81

* Dollar amounts are in thousands.

In the attachment, we provide additional details on a number of concerns you raised. As we indicated in our report, our goal is to identify issues that need to be addressed in the current delivery of the crop insurance program. We want to work with your office to achieve that goal.

ROGER C. VIADERO
Inspector General

Attachment

Individual issues contained in your memorandum, identified by topic and page number are addressed below.

1. Program Vulnerabilities - Page 1

In your memorandum you state that OIG's conclusions regarding loss adjustment errors, conflicts of interest, and RMA's implementation of new policy coverage without proper research are broad conclusions based on anecdotal incidents that do not appear to pass any test of statistical significance. As already discussed in this letter, we have identified systematic problems that need to be addressed. As further discussed below, the issues are based on past audits which show they were not isolated instances of error or abuse.

Loss adjustment errors - In part, the loss adjustment errors identified in Issue 3 came from a 1998 summary report of reviews of claims over \$100,000, which RMA requires reinsured companies to review after they have completed their regular loss adjustment process. Despite the fact that these claims should have already been reviewed and corrected, we questioned over \$980,000 of \$11 million in indemnities (about 9 percent) on 17 of 35 such claims (about 49 percent). This report also summarized 11 other audits and 17 other investigations that reported monetary results of over \$40 million. Such cases are not isolated instances.

Conflict-of-interest situations - OIG has been reporting this condition for several years without the agency taking effective steps to stop inappropriate business relationships between crop insurance sales and loss adjustment personnel. A recent audit showed the conflicts also exist at higher levels between sales and claims management, and even included conflicts which compromised the integrity of the reinsured company's quality control (QC) processes. On May 27, 1999, RMA provided an update to the four recommendations addressing conflict-of-interest issues in our Audit Report No. 05099-2-KC, "Quality Controls for Crop Insurance Determinations," issued July 14, 1998. In its update, RMA stated that it will be conducting an one-time review of reinsured companies' efforts to detect and control potential conflicts of interest, but did not include compliance tests to ensure the QC systems described by the companies were the same as the systems actually in place. As in its earlier proposal, we do not agree to the proposed actions because RMA was not able to provide us adequate assurance us that conflicts would be detected when they occurred and would be prevented from recurring.

Crop insurance policies need additional review and analysis before implementation - This is another issue that we have continued to find during our reviews of the crop insurance program. For example, CRC was initially offered as a pilot program for corn and soybeans in Nebraska and Iowa for the 1996 reinsurance year. In our evaluation report on the CRC Program, Audit Report No. 05801-1-KC, we expressed concerns about major program expansion without proper analyses of the "pilot" program. However, the CRC program was expanded in both 1997 and 1998 to additional crops and coverage areas. For the 1998 reinsurance year, CRC was offered for corn in 29 States, soybeans in 24 States, wheat in 32 States, grain sorghum in 18 States, and cotton in 14 States.

CRC was further expanded for the 1999 reinsurance year to provide coverage for durum wheat even though final regulations for the submission, review, and approval of policies to the FCIC Board have not been published. For the 1998 reinsurance year, the CRC policies covering these commodities collected premiums of about \$333 million and had a liability of about \$4.7 billion even though final program regulations were not published.

During the sales season, it was determined that the formula used to adjust the durum price to reflect the price premium durum has over spring wheat resulted in about a \$2 dollar per bushel bonus for farmers who plant durum. We attribute, in part, the overstated adjustment to the rapid expansion of the CRC program. The excessive cost to RMA for this error could be as high as \$74 million.

Another example of this issue involved coverage provided on popcorn for crop year 1997. During that year, indemnities of over \$5.5 million were paid for popcorn based on an established yield of 73 bushels per acre, when the area only averaged about 40 bushels, and a price per pound of 12 cents when the insureds had contracts with the processor at 7 cents a pound. The policy allowed nonirrigated coverage when the crop is normally produced only with irrigation. In addition, about \$15 million in 1998 indemnities were paid for nonirrigated pima cotton when it was not feasible to produce cotton without irrigation, and the growing season in the four-county area was too short to produce a pima cotton crop.

2. Premium rates - Page 2

In your memorandum, you state that OIG, on page 1, misstated the basis for crop insurance premium rates, appearing to link risk-sharing, farmer out-of-pocket costs, and program effectiveness for limited-resource farmers.

OIG understands the methodology of how premiums are determined. As implied in our report, and as stated by RMA, "premiums are based strictly on risk history and judgements of potential losses." As a result, when losses increase, premiums will subsequently increase, which is the point we are making on page 1 and in Issue 1 of the report. Our intent was to show that improper indemnities were paid because of policy flaws, loss adjustment errors, conflict-of-interest situations, and inadequate oversight of the program which then results in premium increases. Increased premiums cause farmers to not participate in the crop insurance program, which negates the program's intent of replacing disaster programs and functioning as the farmers' safety net against losses. Significantly, the number of crop insurance policies sold has decreased from about 2 million in 1995 to 1.2 million in 1998.

Additionally, we noted that Senator Richard Lugar, Chairman of the U.S. Senate Committee on Agriculture, Nutrition, and Forestry, is also concerned with premium costs and the program's effectiveness as the farmers' safety net. In the April 21, 1999, Senate

hearing on the Federal Crop Insurance Program, Senator Lugar stated that "the crop insurance program seems to be developing into a program in which many high risk farmers participate, but a growing number of farmers are not participating either because it is not economically valuable or because of its complexity."

The relationship between risk sharing and program vulnerabilities has also been brought out by GAO in the past. It only makes sense that the companies who deliver the programs must have an adequate stake in the financial performance of the insurance programs to establish their commitment to effectively manage the program.

Budget - Page 2

In your response, you questioned the \$721 million budget amount for FSA salaries and operations, and the total 1998 costs to the Government for the Federal Crop Insurance Program reported by OIG.

The \$721 million represents the total costs to FSA for its field and State office personnel and related costs. It was not our intent to include FSA National office, Kansas City Commodity office, and Kansas City Management office costs. In computing the costs of delivery for the current system, we also did not include the RMA administrative cost. In our report, we stated that we have not made an in-depth analysis of the costs of a Government-administered delivery system. Our position was simply that there may be an opportunity to have a more effective and economical delivery system than the one currently used.

We also pointed out in our report that the National Association of State Departments of Agriculture (NASDA) has recommended that FSA be the primary deliverer of basic crop insurance coverage. In NASDA's February 22, 1999, policy statement, the association states, "primary delivery of CAT crop insurance should be provided by FSA ... the states should have a role in crop insurance programs as they are uniquely positioned to handle the administration of the crop insurance program."

The \$2.1 billion (for 1998) and the \$8.8 billion (for 1995 through 1998) that we referred to were intended to represent gross Government costs to the taxpayer, which includes indemnities paid to producers. These numbers are based upon the most current data available from RMA at the time we conducted our review (January 1999). The report has been revised to clarify this.

3. Payments to Companies - Page 2

In your memorandum, you state that the 1998 SRA resulted in substantial changes to the Federal Crop Insurance Program: increased risk sharing by the reinsured companies, reduced gain sharing on catastrophic policies, reductions in administrative expense

reimbursements, and enhanced compliance tools. You were concerned that we did not comment on or recognize the changes to the 1998 SRA.

The report has been revised to acknowledge that administrative expense reimbursement percentages had been reduced and that the reinsured companies percentage of underwriting losses had been increased in the SRA effective for the 1998 crop-year.

We compared the insurance experience of 1996 to 1998, for which the loss ratios, indemnity amounts, and the total premiums are similar. Reinsured companies' loss ratios increased from .81 in 1996 to .87 in 1998, an increase of about 7 percent. However, reinsured companies' underwriting gains increased 37 percent, from \$248 million to \$340 million.

Additionally, the reinsured companies' administrative expense reimbursements went from \$468 million for 1996 when 1,623,662 policies were sold (\$288 per policy) to \$419 million in 1998 when only 1,242,629 policies were sold (\$337 per policy).

Comparison of Insurance Experience of 1996 to 1998

	1996*	1998*
Policies	1,623,662	1,242,629
Total Indemnities	\$1,492,804	\$1,636,667
Total Premiums	\$1,839,304	\$1,875,970
Reinsured Companies' Gains	\$248,000	\$340,000
Administrative Expense Reimbursement	\$468,000	\$419,000
Total Reinsured Companies' Revenue	\$716,000	\$759,000
Loss Ratio	.81	.87

* Dollar amounts are in thousands.

Although the reimbursement rate has been reduced to 24.5 percent, higher premium rates in the future will have the affect of increasing RMA's expense reimbursement to the reinsured companies. As GAO stated in its 1997 report,¹ the workload and cost associated with administering an insurance policy do not increase proportionately. The larger the policy premium, the greater the differential between RMA's reimbursement rate and the actual reinsured companies' costs incur to administer the policies.

¹ GAO Report No. GAO/RCED-97-70, Crop Insurance Opportunities Exist to Reduce Government Costs for Private Sector Delivery

General Comments

4. "Page 1, 'Results in Brief' first paragraph." (Your page 3) - In your memorandum, you take issue with our statement that "some RMA policies, particularly those related to risk-sharing with the reinsured companies, have had the effect of increasing premium costs to producers."

As discussed earlier and in Issue 1 of our report, as the potential for underwriting gains increases, there is less incentive to the reinsured companies to properly manage the program and properly perform loss adjustment activities. This scenario increases the probability that improper indemnities will be paid, resulting in succeeding year's premiums to increase. As you stated in your response (page 2), "premiums are based strictly on risk history and judgements of potential losses."

5. "Page 2, 'Results in Brief,' first full paragraph." (Your page 3) - In your memorandum, you take issue with the period of review (1995 through 1998) and point out that we did not perform an analysis of the 1998 SRA. Additionally, you state that the report is based on outdated information.

First, the report is based on data and information provided by RMA. Conclusions in the report are fully supported by related details in the report. The report has been clarified to show the changes to the SRA effective for the 1998 crop year. However, as addressed in detail in Item No. 3 above, reinsured companies' underwriting gains do not appear to have been reduced as a result of the changes to the SRA in 1998. This is also exemplified by the comparison of events between 1996 and 1998 as shown in Item No. 3.

As stated in the cover memorandum, we used the base period 1995 through 1998 in conducting our review for the following reasons:

- Reinsured companies assumed sole delivery of multiple peril crop insurance in 1995 after the last of the master marketer business was phased out in 1994.
- The Federal Crop Insurance Reform and the Department of Agriculture Reorganization Act of 1994 (1994 Act) was signed into law. The 1994 Act added the Catastrophic Risk Protection (CAT) Program to first be delivered in 1995 by the Farm Service Agency and subsequently delivered by only the reinsured companies in 1998.
- The revenue of reinsured companies increased significantly during the period 1995 through 1998. In fact, during the four-year period, the reinsured companies received almost \$1.1 billion of the \$1.26 billion in underwriting gains received since the program began in 1981.

- Any discussion of crop insurance reform should include the most recent performance of the insurance program and the flow of revenue to the companies that deliver the programs.

6. "Page 2, 'Results in Brief,' last full paragraph." (Your page 3) - In your memorandum, you state that OIG has not shown in prior audits that loss adjusters were "pressured" to "rubberstamp" loss claims.

Loss adjusters are pressured by the nature of the business, and directly or indirectly, by both the reinsured companies and the insured farmer. Adjusters are either employees or private contractors and, as such, are impelled to favorably adjust claims to retain customers for the reinsured companies which in turn provide them with employment. As discussed earlier, reinsured companies have minimal risks of losses and want to maintain or expand their books of business in order to continue receiving the unprecedented level of administrative reimbursements and underwriting gains. There is a need for a separation of duties between the loss adjuster and the reinsured companies. For example, as discussed in Issue 2 of our report, sales agents and claims supervisors supervised both sales agents and loss adjusters.² The supervisors had direct control over loss adjustments on policies sold by agents whom they also supervised. In another audit, we found a questionable relationship between a sales agent and loss adjusters. The sales agent, who collected over \$350,000 in indemnities himself that year, provided free office space to two loss adjusters who also verified his loss. The loss was based on the agent's claim that a disaster prevented him from planting his crop, whereas we found evidence that the land had been under water at various times during several years prior to the loss and could not have been planted. Records also showed that the claim was not adjusted until 5 months after the loss.

We believe that if there were a more defined separation between sales and adjusting activities, then there would be less pressure on the loss adjusters to favorably adjust loss claims.

7. "Page 3, 'Results in Brief,' first full paragraph." (Your page 3) - In your memorandum, you state that reinsured companies' capital at-risk has increased from 33 percent of gross premium in 1992 to 80 percent in 1998.

We did not analyze reinsured companies' capital at-risk, and as a result, we are not able to comment on your statement regarding increases in reinsured companies' capital at-risk.

The Deputy Chief Economist provided statistics showing recalculations of the estimated return per dollar of capital risk (ROCR) under the 1995 SRA versus the 1998 SRA.

² Audit Report No. 05099-2-KC, RMA - Quality Control for Crop Insurance Determinations, issued July 14, 1998.

Although estimated ROCR's have decreased under the 1998 SRA, the estimated ROCR's for 1994-1996 were between 24-37 percent.

8. "Page 3, 'Results in Brief,' last partial paragraph." (Your page 4) - In your memorandum, you suggest our statement, "some policies actually encourage abuse," is inflammatory and overstates the limited findings of OIG audits.

The report supports this conclusion by describing the weaknesses in the policies as found during various audits, including audits of the CRC Program, fresh market tomatoes, nurseries, pima cotton and popcorn.

For example, in our evaluation of the CRC Program, which was a major expansion for revenue insurance, we found that RMA did not timely publish regulations to implement legislative changes. It has been over 4½ years since the 1994 Act was signed into law, yet regulations implementing the Act's requirements have not been finalized.

Regarding your comment of "limited findings" for the period of October 1, 1998, through March 31, 1999, we identified over \$541 million in questioned or unsupported program costs during audits of crop insurance. Of the \$541 million, RMA agreed with \$426 million.

Our investigations also reported substantial questioned indemnities and improprieties. For the period fiscal year 1988 through the current 1999, Investigations issued 236 reports with monetary results³ totalling about \$31 million. The dollar amounts of both Audit and Investigations' results clearly challenges your statement of OIG's "limited findings."

9. "Page 5, 'Results in Brief,' last partial paragraph." (Your page 4) - In your memorandum, you state that crop insurance error rates are well below industry commercial insurance markets.

Our concern regarding error rates used to infer program improvement is discussed in the cover memorandum.

10. "Page 6, 'Suggested Corrective Actions,' first paragraph." (Your page 4) - In your memorandum, you state that there have been changes in the SRA for 1998, specifically administrative expense reimbursements have been reduced and reinsured companies' assumed risks have increased.

The report has been revised to recognize the changes in the 1998 SRA. Although the administrative expense reimbursement percentage has been reduced and the percentages

³ Monetary results consist of fines, restitution, administrative penalties, and collection and recovery amounts.

of potential underwriting losses have been increased, the potential for underwriting gains actually increased with the 1998 SRA. Specifically, while the gain sharing percentages for CAT policies were decreased, the underwriting gain percentages for buyup (that is, multiple peril crop insurance and revenue) policies were increased: underwriting gain percentages for 6 of the 18 risk pools for buyup policies were increased (by an average of 13 percent) and the percentages for the other 12 pools were unchanged. And buyup policies constitute a far larger share of the reinsured companies' book of business; for the over 1.2 million policies sold in 1998, over 845 thousand (or 68 percent) policies were buyup policies. In addition, as shown in the table in Item No. 3, the reinsured companies' administrative expense reimbursements have not decreased proportionately to the decrease in the number of policies sold and serviced.

Issue 1

11. "Page 9" (Your Page 4) - In your memorandum, you question the amounts used in the report regarding total cost of the insurance program to the government, you mention the increases in reinsured companies' assumed risk, and you take issue with our inclusion of the fact that \$6 billion had been appropriated for reduced farm prices for insured and uninsured crop losses resulting from widespread disaster. You also point out that, according to an independent analysis conducted by USDA's Office of the Chief Economist, should a 1988-type drought occur today under the new SRA, net underwriting losses for participating companies could reach \$450 million in a single year. Our concerns with your use of the \$450 million loss figure are discussed in the transmittal memorandum for this attachment.

The \$2.1 billion (for 1998) and the \$8.8 billion (for 1995 through 1998) that we referred to were intended to represent gross Government costs, including indemnities paid to producers. The report has been revised to clarify this. Item No. 2 of the attachment also includes information regarding this issue.

12. "Page 10." (Your page 5) - In your memorandum, you agree with information cited from a General Accounting Office report that since 1995, CAT costs have more than doubled on a per-policy basis, from \$203 in 1995 to about \$443 in 1998. You state that "while these figures are correct, the report fails to explain why the cost increased. The average CAT policy has grown sharply in size during this period-from \$7,190 of liability per policy in 1995 to \$17,900 of liability per policy in 1998. Because the policies are larger, the cost per policy has grown. This fact has driven this cost increase more than any other factor."

We agree that the size of the CAT policies has grown substantially. Since assuming full delivery of the CAT Program, the reinsured companies have focused their sales efforts on larger farmers to maximize their underwriting gains, which represent most of the delivery costs for this program. At the same time, reinsured companies have not kept their promise to the Secretary to adequately serve small farmers under this program.

These farmers are essentially farming without a safety net for their operations, even though the CAT program will provide them insurance coverage at no cost. The participation of small or limited resource farmers has dropped 78 percent from 1997 to 1998, the period when reinsured companies assumed sole delivery of the CAT program.

RMA was informed two years ago in 1997 that it needed to control CAT underwriting gains, but has not done so. In its April 1997 report on "Opportunities Exist to Reduce Government Costs for Private-Sector Delivery," GAO recommended that the Administrator of RMA "determine the compensation that reflects the appropriate and reasonable costs of selling and servicing catastrophic crop insurance and include it in the new agreement being developed with the companies; and closely monitor the experience of the catastrophic insurance program to ensure that over time the underwriting gains earned on catastrophic insurance by the companies do not exceed FCIC's long-term target for gains." Minor adjustments were made in the 1998 SRA, but the compensation issue still exists today for 1999 as well as for the 2000 reinsurance year. RMA has already rolled over the terms of the current SRA to the 2000 reinsurance year, but did not make any adjustment in the provisions for underwriting gains for CAT policies.

We show in the following table how underwriting gains for CAT policies have actually increased from 1996 to 1998, years with similar loss ratios. In addition, data in the table shows how CAT insurance experience reduces the overall loss ratio of the program which increases gain amounts received by the reinsured companies.

Program Year	1995*	1996*	1997*	1998*	Total
CAT Premium	\$455,957	\$430,174	\$349,086	\$358,898	\$1,594,115
CAT Indemnity	\$167,607	\$150,019	\$43,636	\$110,508	\$471,770
CAT Loss Ratio	.37	.35	.13	.31	.30
Reinsured Company Underwriting Gain	\$46,600	\$62,300	\$86,800	\$109,500	\$305,200
4 Year Return of Gain to CAT Premium					19%
Buy-up Premium	\$1,087,344	\$1,409,116	\$1,425,672	\$1,515,971	\$5,438,103
Buy-up Indemnity	\$1,400,279	\$1,342,811	\$948,613	\$1,541,253	\$5,232,956
Buy-up Loss Ratio	1.29	.95	.67	1.02	.96
Reinsured Company Underwriting Gain	\$84,300	\$183,500	\$273,400	\$226,300	\$767,500
4 Year Return of Gain to Buyup Premium					14%
Combined Loss Ratio	1.02	.81	.56	.88	.81

* Dollar amounts are in thousands.

You also point out that GAO specifically recommended that the administration and operating (A&O) reimbursement rate to reinsured companies be reduced to 24 percent, and since the current A&O rate is 24.5 percent, then RMA has achieved GAO's target. However, RMA does not mention that GAO also recommended that RMA monitor company expenses to ensure that the established rate is reasonable for the services

provided. RMA has already extended the same A&O rate to the 2000 reinsurance year without conducting any reviews to determine the reasonableness of the existing rate.

13. "Page 11." (Your page 5) - In your memorandum, you state that there is no supporting evidence that reinsured companies received significant revenue increases as a result of the shifting of CAT policies from FSA to the reinsured companies.

Information regarding increased gains resulting from imputed CAT premiums is included in the details of Issue 6. Our position is that as reinsured companies focused their CAT sales efforts towards the larger producers, imputed premiums also increased, which then caused reinsured companies' underwriting gains to increase.

We did not reference Issue 6 "for supporting documentation," rather just for additional information on the subject matter being discussed. We do not agree with your assertion that "the text of Issue 6 suggests the opposite conclusion." Issue 6 shows that there has been a decline in participation in the CAT program by smaller farmers caused in part by reinsured companies not servicing the smaller farmers. We also show how reinsured companies increase revenues by selling CAT coverage to the larger farmers which will have higher imputed premiums. As imputed premiums increase, reinsured companies' gains increase because of the historically low loss ratios experienced by the CAT producers. The table in Item No. 12 of the attachment clearly shows the effect of CAT imputed premiums on the overall loss ratio and gains received by reinsured companies. For the 4-year (1995 - 1998) period, the CAT Program's lower loss ratio (of 0.30) helped to reduce the reinsured companies' overall loss ratio to .81, since the reinsured companies' loss ratio on buyup coverage (which constituted a far larger share of their book of business) to .96.

Regarding your concern that 1998 data was not used in our analysis of ceded premiums, 1998 data was not used because that information will not be available for review until June 1999.

14. "Page 13." (Your page 5) - In your memorandum, you state that OIG incorrectly reported the cost of the FSA program.

Our comments concerning this issue are shown in Item No. 2 above.

Issue 2

15. "Pages 14-15." (Your page 5) - In your memorandum, you question the number of conflict-of-interest situations reported by OIG. You further conclude that a pervasive pattern of conflict-of-interest situations does not exist.

This issue has already been discussed in the cover letter and in Item No. 1 of this attachment.

Issue 3

16. "Pages 17-19." (Your page 6) - In your memorandum, you state that OIG has not recognized the remedial actions taken by RMA to improve the ongoing effectiveness of RMA's compliance oversight program, specifically, monitoring of reinsured companies' oversight and quality control reviews of loss claims. You also comment that the agency has been successful in recovering monies from the reinsured companies for errors committed by company employees or representatives.

OIG does recognize the efforts of the RMA's compliance staff; however, we continue to find (1) significant errors made by loss adjusters (see Item No. 1) and (2) superficial, if any, quality control reviews conducted by the reinsured companies. As previously mentioned, part of the loss adjustment errors identified in Issue 3 of the report came from a summary report (Audit Report No. 05601-3-Te) of reviews of claims over \$100,000, which RMA requires reinsured companies to review after they have completed their regular loss adjustment process. Despite the fact that these claims should have already been reviewed and corrected, we questioned over \$980,000 of \$11 million in indemnities (about 9 percent) on 17 of 35 such claims (about 49 percent).

In the report, we did not address RMA's effectiveness in recovering monies from reinsured companies for errors committed by their employees and/or representatives. We presently have underway an audit survey in this area to determine how well questioned claims have been processed and collected.

Issue 4

17. "Page 20." (Your page 6) - In your memorandum, you point out that high yield figures for cotton were limited to four counties in Texas and for corn were limited to one county.

The point that we were making in Issue 4 was that RMA does not always conduct sufficient or accurate research and development of crop insurance policies before those policies are implemented, and it does not ensure that potential consequences of changes in the crop insurance program are adequately addressed before those changes go into effect. In addition to the examples involving cotton and corn, the report included a number of other instances where we identified these types of weaknesses.

18. "Page 21, Crop Insurance on Fresh Market Tomatoes." (Your page 6) - In your memorandum, you question our conclusions regarding the audit of the crop insurance program for fresh market tomatoes.

In our report, we showed that the program, as implemented, allowed indemnity payments to be paid to producers who did not experience a loss in quantity or quality of production, but instead suffered financial losses due to low market prices, even though this was not intended under the policy. We noted one example where the producer elected not to

harvest because of low market prices, and received indemnities totaling \$41,430 on that particular unit of tomatoes. In his records, we found a memo that read "we elected not to pick this field for the packing house because the market price was below harvest and packing costs." Based on this memo, it is very clear to us that the producer elected not to harvest his tomatoes because of the low market price, and shows the memo was not taken out of its proper context.

In a memorandum, dated July 8, 1998, the Office of the General Counsel advised that:

FCIC does not have any authority under the Tomato Policy to pay a claim based solely on the loss of market price. The Federal Crop Insurance Act (Act) is clear that a production loss or damage is required. Since OIG has identified a policy flaw or loophole that results in the payment of indemnities in violation of these provisions of the Act, the provisions of the Tomato Policy must be revised as soon as possible to bring it back into conformance with the Act.

19. "Page 22." (Your page 6) - In your memorandum, you state that OIG did not report the agency's corrective actions and revised actuarial documents for 1999 which corrects the situation.

As previously stated, the popcorn yields were established substantially higher than the average yields for the area, the price was too high, and it was not a normal practice to grow popcorn on nonirrigated acreage. We agree that once the problems were identified, RMA took action to correct them. However, we found that in at least one instance, RMA field staff advised RMA actuarial staff of their concerns that yields were too high, but the yields were not changed until after the policy was implemented. Our point was that such potential weaknesses should have been identified before the insurance was offered to the farmers.

20. "Page 23, 1994 Reinsured Raisin Losses in California" (Your page 7) - In your memorandum, you state that raisin losses were the result of fraudulent statements made by some producers, agents, loss adjusters, and third party processors. You also stated that corrective actions taken by RMA were not included in the report.

We agree that the raisin losses occurred, in part, because of fraudulent statements made by some producers, agents, loss adjusters, and third party processors. This case clearly demonstrated collusion between loss adjusters and sales agents and how loss adjustment activities were poorly performed and not detected because of weaknesses in the policy.

As previously stated, Issue 4 addressed weaknesses in crop insurance policies that could have been avoided if policies had been properly researched and developed before being implemented. Weaknesses in the raisin policy and procedures rendered the program susceptible to abuse by reinsured companies. For example, the raisin policy did not limit the amount of insured production to a producer's history of production or include coverage for reconditioning costs. Also, RMA did not have a methodology developed

which would require raisin growers to recondition raisins instead of allowing them to be sold as salvage. These and earlier examples all support the need for better research before implementing policies.

21. "Page 23. Guaranteed Prices for 1999 Durum Wheat Under Crop Revenue Coverage." (Your page 7) - In your memorandum, you acknowledge the problems with the policy on durum wheat, and point out that "RMA acted promptly to correct the situation."

Again, our point was that the policy was implemented without adequate research and development. As mentioned in Item No. 1, the excessive cost to RMA for the error involving durum wheat could be as high as \$74 million.

22. "Page 24. Initiatives by Reinsured Companies Also Need Oversight." (Your page 7) - In your memorandum, you state that no actions taken by the agency to resolve this concern were included in the report.

Again, the point of Issue 4 was to address the need for more effective research and development before policies were implemented. We acknowledge that once the problems arose, RMA initiated action to address the problems.

23. "Page 25. Suggested Corrective Action." - In your memorandum, you question whether our suggestion that a computer model be developed and used to identify flaws in new policies is feasible in all situations.

We agree with you that a computer model may not be the answer to solve all the problems resulting from new policies. However, given the degree of problems that have been identified, we believe that RMA needs to establish a better methodology to review or test such policies before they are implemented.

A prime example where further review and analysis were needed involves the nursery insurance program. RMA contracted with a private company to develop a listing of insurable plants with appropriate insurable values. However, the final plant listing as provided by the contractor, and as used by RMA, was flawed. The plant listing was missing over 1,000 plant types that were routinely insurable in the past. Additionally, the plant listing contained substantially inflated plant values. For example, the plant listing showed the insurable value for a one-gallon poinsettia to be \$17.49. This plant is commonly available in the retail market for \$2.97 each. Both industry and RMA regional service office officials reported the flaws to RMA; however the agency did not take immediate action to correct the problem.

As an alternative to a computer model to analyze crop insurance policies prior to implementation, RMA could institute guidelines similar to those required for policies submitted under section 508(h) of the Act. For example, the proposed rule for Submission of Policies requires a certification from an accredited associate or fellow of the Casualty Actuarial Society or a similar uninterested third party or peer review panel or both, to perform an evaluation of all supporting documentation and analyses. The

evaluation must demonstrate that the submission is consistent with sound insurance principles, practices, and requirements of the Act.

Issue 5

24. "Page 27." (Your page 8) - In your memorandum, you take issue with our suggestion that the agency rescind its optional unit policy. You state that such a change would gravely disadvantage hundreds of thousands of farmers who rely on this feature, the vast majority of whom act with integrity and honesty.

As stated in the report, the optional unit policy allows producers to shift production to maximize indemnities. In addition, it allows reinsured companies to use the policy as a marketing tool to increase sales and ultimately increase revenues.

Based on our review of a random sample of 60 policies with indemnities, we statistically projected that, for crop year 1991, net costs to the Government could have been reduced by as much as \$336.7 million if the units had been limited to one per county or to basic units. In reaching management decision on this monetary amount, RMA concurred with \$226 million of the total monetary exceptions.

Furthermore, in Audit Report No. 05600-6-Te, we pointed out that, in 1985, Federal Crop Insurance Corporation (FCIC) proposed that multiple units be discontinued for crop year (CY) 1986 and that policyholders be restricted to one unit per State. This was not done because the insurance industry predicted that there would be mass cancellations if the single unit policy was instituted. However, our analysis of the number of insured acres from 1979 to 1992 showed that multiple units had done little to increase participation since participation did not increase significantly until CY 1989 when Congress made it mandatory to purchase crop insurance in order to obtain Agricultural Stabilization and Conservation Service (ASCS) disaster payments. In its March 2, 1994 evaluation entitled "Blueprint for Financial Soundness," FCIC pointed out that its research indicated that smaller units may have a greater loss than larger units and that the more flexible the units, the more costly it is. Also, in an April 12, 1994, memorandum to the respective agency heads, the FCIC Assistant Manager for Compliance and the ASCS Deputy Administrator for State and County Operations identified as a program policy issue the need to eliminate multiple payments in 1 year to producers who experience limited losses. The memorandum contained the following two recommendations:

In anticipation of crop insurance being the primary means of loss protection, develop a "whole farm" policy that protects against net loss.

Limit crop insurance units to farm serial numbers. This change would reduce abuse and premium risk as well as facilitate proposed crop reform and USDA reorganization.

During recent discussions, you agreed that it would be appropriate to further study the multiple units issue.

Issue 6

25. "Page 27." (Your page 8) - In your memorandum, you state that the reduction in CAT policies sold to limited-resource producers are not related to the failure of reinsured companies to redistribute underwriting gains or to the transfer of this program from dual delivery (by reinsured companies and FSA) to single delivery by reinsured companies.

Considering that (1) there was a 78 percent reduction in CAT policies sold to limited-resource producers from 1997 to 1998, and (2) reinsured companies have tended to focus their sales and servicing activities towards larger producers or producers with high-value crops, we believe that RMA should study the suggestions included in our report in an effort to promote the crop insurance program as a "safety net" for all qualified producers, including small and limited-resource producers.

26. "Page 28." (Your page 8) - In your memorandum, you state that, starting in 1999, the CAT administrative fee goes to the Government-not the reinsured companies.

We acknowledge the change. The \$50 rate included in the report was in effect during the years 1995 through 1998, the time period being addressed. Again, the point of Issue 6 was that the reinsured companies are not utilizing the substantial underwriting gains to encourage and expand crop insurance coverage, especially for the CAT Program, to as many producers as possible, regardless of size. The potential for large underwriting gains remains high.

27. "Page 29." In your memorandum, you state that our recommendation to increase the value of CAT imputed premiums for smaller farmers violates the law.

We did not discuss the administrative expense reimbursements for CAT, for which there are none. The law may govern the value of imputed CAT premiums of smaller farmers; however, there should be other alternatives to correct the situation addressed in Issue 6. OIG offered the suggestion as a possible solution to provide incentives for reinsured companies to provide the same services to smaller farmers as they do for larger farmers. Another alternative could be that proposed by the NASDA, previously discussed. We believe that RMA should address this issue by developing some type of system to adequately service the smaller farmers.

Issue 7

28. "Page 3-4, 20, 30-Nursery Insurance." (Your page 8) - In your memorandum, you state that OIG created a misimpression regarding the agency's role in improving the crop insurance program for nurseries.

We agree that RMA participated in our 1998 audit of nurseries and that there have been improvements made to the nursery policy. However, errors such as reported in item 23 above lessen the effect of these efforts. Furthermore, the nursery report was issued on

December 16, 1998, at which time there were 10 unresolved recommendations. To date, we have not received a response from RMA advising of additional actions to be taken regarding any of the 10 recommendations.

29. "Page 32." (Your page 8) - In your memorandum, you state that regional service offices (RSO) are highly involved in the new product development process.

During our review of RSO operations, we found that when new crops were being researched, all RSO's having major producing areas were not required to participate in policy development. In an internal memo dated July 28, 1997, the Program Services Branch pointed out that RSO's which have major producing areas should be required to participate in the initial phase of new crop research. The memo stated that the melon development team, researching cantaloupes and watermelons, did not have RSO representation from three States with considerable melon production (Texas, California, and Arizona). The memo further stated that this situation could lead to adverse selection and inappropriate policy development.

Issue 8

30. "Page 34." (Your page 9) - In your memorandum, you state that OIG did not report efforts made to improve the agency's compliance activities within the scope of available budget and staffing.

We recognize that there have been improvements made regarding RMA's compliance activities. However, as discussed in the report, we believe that RMA should more effectively utilize its Risk Compliance to identify and report weaknesses in the crop insurance program.