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Subject: Crop Insurance: Increases in Insured Crop Prices and Premium Rates Raise the Administrative Expense Reimbursement Paid to Companies

This year the Congress will once again be considering reforms to the federal crop insurance program. During the 1997 debate on crop insurance, the financial arrangement between the federal government and private insurance companies that sell and service crop insurance on behalf of the federal government was a source of considerable controversy. One aspect of this controversy was the size of the payment the government provides the companies to reimburse them for their administrative expenses associated with selling and servicing crop insurance. This reimbursement is currently calculated as a preestablished percentage of the total premiums paid. In 1997, administrative expense reimbursements totaled more than $450 million. The Federal Crop Insurance Corporation (FCIC), under the management of the Risk Management Agency, is responsible for determining an appropriate administrative expense reimbursement and for making payments to the private insurers.

In our April 1997 report entitled Crop Insurance: Opportunities Exist to Reduce Government Costs for Private-Sector Delivery (GAO/RCED-97-70, Apr. 17, 1997), we recommended that the reimbursement rate for administrative expenses be substantially reduced. Our recommendation was based on our assessment of the companies' reported expenses for 1994 and 1995, as well as our identification of the factors emerging after 1995 that served to increase the amount of administrative reimbursements the companies would receive. In particular, we pointed out that higher insured crop prices and premium rates led to higher premiums in 1996 and 1997 and that because total administrative reimbursement payments to companies are based on a preestablished percentage of premiums, the 1996 and 1997 reimbursement



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payments to companies also increased without a commensurate increase in their workload.

Since then, more experience with insured crop prices and premium rates provides additional perspective on some of the issues raised in our report. As the Congress moves forward in its deliberations on funding the crop insurance program, we believe it should have this new information. Accordingly, this report provides updated data on insured crop prices and premium rates and assesses their impact on the administrative reimbursements the companies will receive in 1998. Because the existing reimbursement method does not provide a basis for adjusting the reimbursement rate to reflect changes in insured crop prices and premium rates, this report also discusses an alternative being considered by FCIC that would use a crop price index–which would adjust premiums for fluctuations in crop prices–to calculate companies' expense reimbursements. In addition, this report summarizes other alternative reimbursement methods that were presented in our April 1997 report and that FCIC is considering. These other alternatives also offer the potential to better match reimbursements with companies' administrative expenses and reduce program costs.

In summary, we found that average insured crop prices and premium rates have increased more since our April 1997 report. These increases have generated a 16-percent increase in the total crop insurance premiums paid since 1995. Because the administrative expense reimbursement paid to crop insurance companies is calculated as a percentage of total premiums, the increase in premiums will result in even higher payments in 1998 without a commensurate increase in workload. Unless the current reimbursement percentage is reduced and/or the method for calculating reimbursements is modified, companies' reimbursements for administrative expenses will continue to exceed their workload.

## BACKGROUND

To reimburse insurance companies for the expenses of selling and servicing crop insurance policies, FCIC pays them an administrative fee that is based on a preestablished percentage of premiums.[1] The administrative expense reimbursement is intended to cover the companies' costs of selling and servicing crop insurance policies and is not intended to provide a profit. Companies have the opportunity to earn profits from crop insurance sales by sharing underwriting risk with FCIC. They earn money when the premiums exceed the crop loss claims paid for those policies on which the companies retain risk. They lose money when the claims paid for crop losses on the policies they retain exceed the premiums. Overall, since 1990, the companies participating in this program have collectively earned nearly $1 billion in underwriting profits.

As we reported last year, the administrative expense reimbursements FCIC paid to the participating companies in the years we analyzed--1994 and 1995--were much higher than the incurred expenses that can be reasonably associated with the sale and service of federal crop insurance. On the basis of our assessment of company-reported expenses, we determined, and FCIC concurred, that the companies' expenses reasonably associated with the sale and service of federal crop insurance in 1994 and 1995 totaled about 27 percent of the premiums paid in those years. Because the companies were paid a reimbursement totaling 31 percent of premiums in those 2 years, the companies made a profit on the administrative expense reimbursement.

Our report also noted that higher insured crop prices and higher premium rates had increased the administrative expense reimbursements paid to companies after the 1994-95 period we analyzed. Specifically, we pointed out that from 1995 to 1997, higher insured crop prices and higher premium rates led to a 13-percent overall increase in premiums. After weighing the impact of this increase, we concluded that FCIC could reduce the reimbursement rate another 3 percentage points below the 27-percent level we found to be justified in 1994 and 1995--to a level of 24 percent of premiums--and still adequately reimburse the companies for their administrative expenses.

In commenting on our report, the industry expressed concern that the implementation of our recommendation to reduce the reimbursement rate for

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[1]This reimbursement rate has declined from 31 percent of premiums paid in 1994, 1995, and 1996; to 29 percent in 1997; and finally, to 27 percent in 1998. The 1997 rate was mandated by the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, and the 1998 rate resulted from provisions in the Department of Agriculture Appropriations Act of 1998.

administrative expenses would destabilize the crop insurance industry. The industry asserted that it would not be appropriate to adjust this rate on the basis of changes in insured crop prices and premium levels that could go down as well as up. In this regard, the industry referred to the premium increases we identified as "speculative." However, the 1996 and 1997 insured crop price increases and premium rate increases we referred to were not speculative; they had already occurred, and companies were already benefiting from the reimbursement windfall. As we reported in April 1997, the insured crop prices FCIC used to establish crop insurance premiums for six major crops increased by 9.2 percent[2] in the 2 years immediately after the 1994-95 period we reviewed.

## INSURED CROP PRICES AND PREMIUM RATES CONTINUE TO EXCEED 1995 LEVELS

Following our report, FCIC established its insured crop prices for 1998. These prices were similar to the 1996 and 1997 prices we cited in our report. Thus, for the third year in a row, average insured crop prices remained substantially above the levels in place during the 1994-95 period we analyzed, contrary to the concerns raised by the companies about potentially lower prices. As shown in table 1, average insured crop prices increased by 10.2 percent from 1995 to 1998.

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[2]Subsequent to the preparation of our report, FCIC's insured crop price for peanuts was changed from $0.34 to $0.31. This resulted in a slight change–from 9.2 to 8.9–in the overall weighted average percent increase in insured crop prices from 1995 to 1997.

Table 1: FCIC's Insured Crop Prices Used in Determining Traditional Crop Insurance Premiums

| Crop | FCIC's insured crop prices | | | | Percent increase from 1995 to 1997 | Percent increase from 1995 to 1998 |
|---|---|---|---|---|---|---|
| | 1995 | 1996 | 1997 | 1998 | | |
| Soybeans (per bushel) | $5.50 | $6.75 | $6.15 | $6.00 | 11.8 | 9.1 |
| Grain sorghum (per bushel) | 2.10 | 2.50 | 2.30 | 2.30 | 9.5 | 9.5 |
| Corn (per bushel) | 2.25 | 2.65 | 2.45 | 2.60 | 8.9 | 15.6 |
| Wheat (per bushel) | 3.35 | 3.55 | 3.85 | 3.65 | 14.9 | 9.0 |
| Peanuts (per pound) | 0.34 | 0.34 | 0.31 | 0.31 | -8.8 | -8.8 |
| Cotton (per pound) | 0.68 | 0.67 | 0.69 | 0.71 | 1.5 | 4.4 |
| Weighted average percent increase[a] | | | | | 8.9 | 10.2 |

[a]Weighted by 1995 crop insurance liabilities for each crop.

Source: GAO's analysis of FCIC's data.

Premium rates have, on average, also continued to increase from the 1994-95 period we analyzed. The companies argued that premium rate increases do not justify a reduction in the rate for the administrative reimbursement because FCIC could, on the basis of its annual rate review, reduce rates as well as raise them. While premium rate decreases are certainly possible, for the years since the 1994-95 period we analyzed, average premium rates have consistently risen. Specifically, in keeping with its efforts to achieve actuarial soundness in the program, FCIC increased the average premium rates for traditional crop insurance by about 4 percent from 1995 to 1996, by about 1 percent in 1997, and once again by about 1 percent in 1998.

Collectively, the increases in insured crop prices and in premium rates have generated a 16-percent increase in total premiums from 1995 to 1998–an additional 3 percent above the 13-percent increase that occurred from 1995 to 1997. As a result of the increase in the premiums updated to reflect 1998 prices and premium rates, we estimate that a reimbursement rate of 23 percent of premiums would now be sufficient to reimburse companies for their reasonable expenses associated with selling and servicing crop insurance. This is 1 percentage point less than we calculated in our April 1997 report.

The current 27-percent reimbursement rate applied to the higher premiums now being paid is generating even more income to the companies than it did last year because the increase in the companies' reimbursements associated with the higher premiums has not been accompanied by a proportionate increase in the companies' workload. Companies' administrative work processes remain essentially the same regardless of the premium charged. For example, the cost of data entry and transmission is a function of the number of documents and data elements processed and transmitted, not the premiums those documents represent. Similarly, the cost of loss adjustment is a function of the frequency and nature of crop loss, not the premiums charged on the damaged crops. Thus, as premiums increase, the companies receive windfall increases in their income unless the reimbursement percentage is reduced and/or the method for calculating reimbursements is modified.

## ALTERNATIVE REIMBURSEMENT METHODS OFFER THE POTENTIAL TO BETTER MATCH REIMBURSEMENTS WITH COMPANIES' ADMINISTRATIVE EXPENSES

The current method for reimbursing companies for their administrative expenses–under which FCIC pays private companies a fixed percentage of premiums–does not provide a mechanism for adjusting the reimbursement in response to changes in the premium rates or insured crop prices. However, FCIC is considering an alternative reimbursement method–crop price indexing–that would account for changes in insured crop prices. In addition, FCIC is considering other alternative reimbursement methods that we presented in our April 1997 report. These alternatives offer the potential to better match reimbursements with companies' administrative expenses and reduce program costs. All of these alternatives are discussed below.

Use a Crop Price Index

A crop price index could be used to reduce the annual variability of insured crop prices for the purpose of calculating companies' administrative expense reimbursements. This alternative would require developing an insured crop price average as a baseline and then annually adjusting (or indexing) policy premiums–for expense reimbursement purposes–to this average before calculating companies' expense reimbursements. Compared with the current reimbursement method, crop price indexing would provide a consistent premium basis for calculating administrative expense reimbursements regardless of changes in crop prices.

Cap the Reimbursements per Policy

As we reported in April 1997, one alternative would be to cap the amount of administrative expenses reimbursed to companies per policy. Because the companies' workload generally does not increase proportionately as policy premiums increase, placing a cap on the amount reimbursed per policy would eliminate high reimbursement payments for large or high-premium policies.

Pay a Flat Amount per Policy Plus a Percentage of Premium

This alternative would consist of a flat fee per policy plus a percentage of premium. This alternative takes into consideration that for each crop insurance policy written, an insurance company must perform some fixed minimum level of work, regardless of the premium. The company then performs additional work that varies, generally depending on the size of the farm and the value of the crops insured. Paying companies a fixed amount plus a percentage of premium recognizes both the fixed and variable aspects of selling and servicing crop insurance policies. Furthermore, with this methodology, reimbursements would be less sensitive to changes in crop prices because much of the reimbursement would be fixed and not affected by these changes.

Reduce Reimbursement Rates as Premium Volume Increases

Another alternative would be to reduce each company's administrative reimbursement rate as its total premium volume increases, using preestablished percentage rates for different increments of the total premium. This alternative recognizes that fixed expenses–such as investments in equipment and facilities, annual training, and state licenses and fees–decrease as a percentage of the total premiums written as premium volume increases.

## SCOPE AND METHODOLOGY

We analyzed FCIC's data on insured crop prices and premium rates for 1996, 1997, and 1998. We used these data to update information presented in our April 1997 report and to assess the validity of industry challenges to our report's conclusions. We performed this work during February and March 1998 in accordance with generally accepted government auditing standards. Although we did not independently assess the accuracy and reliability of FCIC's databases, we used the same files FCIC uses to manage the crop insurance program. We discussed this report with the Risk Management Agency officials who manage FCIC. They generally agreed with our analysis and provided technical clarifications, which we incorporated as appropriate.

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If you have any questions about this report, please contact me on (202) 512-5138. Major contributors to this report were Ronald E. Maxon, Jr., Thomas M. Cook, Ruth Anne Decker, and Robert R. Seely, Jr.

Robert A. Robinson
Director, Food and
Agriculture Issues

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