Federal Crop Insurance Corporation

USDA Risk Management Agency

Expert Review Report

FCIC Board Requested Review

Premium Reduction Plan (PRP) Issues

CI-Premium Reduction Plan Issues-04-02

FCIC Board Memorandum No. 785

BPA 45-RMA1-4-0039

Call Order # RMA-05-0002

Deloitte Consulting LLP

January 7, 2005

Deloitte.

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January 7, 2005

Ms. Patty Cochran, Contracting Specialist
FCIC/Risk Management Agency
US Department of Agriculture
Kansas City Administrative Office
P.O. Box 419205
Kansas City, MO, 64141-6205

RE: Blanket Purchase Agreement (BPA) 45-RMA1-4-0039
Call Order # RMA-05-0002
Premium Reduction Plan (PRP) Issues
CI-Premium Reduction Plan Issues-04-02
FCIC Board Memorandum No. 785
Expert Review for the FCIC Board of Directors

Dear Ms. Cochran:

Enclosed you will find our expert review report for the FCIC Board of Directors concerning the "Premium Reduction Plan Issues." This report will present the executive summary and research report of our expert review in accordance with the Section 505(e) of the Federal Crop Insurance Act (7 U.S.C 1501(e)).

If the FCIC Board of Directors has any questions regarding this report, please do not hesitate to contact me.

Sincerely,

Robert S. Miccolis, FCAS, MAAA
Director, Deloitte Consulting LLP

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I. Executive Summary

Deloitte Consulting LLP (Deloitte Consulting) has conducted an expert review of the "Premium Reduction Plan Issues." The purpose of this independent expert review and analysis is to present our analysis of several important issues that have arisen in the RMA's review and FCIC Board's consideration of recent applications for Premium Reduction Plans. This expert review will provide the Board with information to enhance the Board's understanding of the critical issues presented by the new applications and to advise the Board concerning whether a proposed rule appropriately addresses the substantial increase in complexity and expanded role of premium reduction plans in the federal crop insurance program. This review will not recommend approval or disapproval of any particular Premium Reduction Plan (PRP) submitted by an Approved Insurance Provider (AIP). Our recommendations regarding these issues are as follows:

Deloitte Consulting recommends that the FCIC:

1. Conduct a scientific survey of producers and agents, specifically to gauge the relationships that the Board is most interested in, to obtain useful and objective information for evaluating the effectiveness of crop insurance as a risk management tool.
2. Require an attestation signed by a responsible officer of the AIP, such the president or chief underwriting officer, that the AIP has sufficient controls in place to prevent, detect, remedy or mitigate the negative impacts from the submitted premium reduction plans could have on the agent work force, on agent training, on claims adjustment, on approved insurance providers, on the crop insurance marketplace, and on service to producers.
3. Require an AIP to offer its PRP in all states and for all plans of insurance, unless the AIP can demonstrate that the underlying expense efficiencies have been significantly different by state or by plan of insurance, as verified through an independent review or based on expense data reported to the RMA; and to demonstrate, with an analysis of expense experience data, that the PRP is not unfairly discriminatory between PRP and non-PRP insureds.
4. Allow an AIP to offer a PRP in a limited number of states, or for one or more selected plans of insurance, on a pilot basis for a limited pilot period, provided that the AIP does not have more than one pilot PRP available for any crop year.

5. Require the AIP to report expense data to the RMS separately for PRP and non-PRP business.
6. Allow the AIP to select the states for a PRP, based on state differences in operating expenses, subject to RMA review and acceptance.
7. Review the current A&O reimbursement/subsidy structure to consider paying a higher percentage A&O subsidy to AIPs for producers with small premiums and a smaller percentage A&O subsidy to AIPs for producers with large premiums.
8. Require the AIP to report data for PRP vs. non-PRP insureds that profiles the premium size distribution of producer premiums for PRP vs. non-PRP insureds, including an analysis that demonstrates how their PRP was not unfairly discriminatory.
9. Allow, but do not require, the phase in of a PRP, similar to a pilot basis.
10. Require a pilot or phase-in be completed within no longer than 3 years.
11. Treat changes during a phase-in period the same as if the PRP was being withdrawn and a new PRP was being submitted to replace it.
12. Require the AIP to submit a reconciliation of reinsurance year expense data to a calendar year basis and reconcile to expense data in the Insurance Expense Exhibit for the Multiple Peril Crop Insurance Line of Business (line 2.2), subject to independent verification, if requested by RMA.
13. Require the AIP to attest to the accuracy and reasonableness of the expense information submitted to the RMA.
14. If the RMA cannot test the expense information provided by the AIP to the RMA, require the AIP to hire an independent accountant to perform agreed upon procedures related to the expense information. The specific agreed upon procedures should be reviewed by more than one accounting firm to confirm that such procedures meet their professional guidelines.
15. Develop guidelines for the identification of costs and the allocation of expenses to an AIP's insurance business under the federal crop insurance program business, and to a PRP. Require an AIP to submit its detailed expense cost identification and allocation procedures, with examples, for how the AIP allocates its expenses to this crop insurance business and to a business under a PRP. The PRP submission should then be subject to an expert review by a qualified expert.

16. Develop cost accounting guidelines using the approaches described in the IASA Property-Casualty Insurance Accounting textbook, and allow each AIP to adapt its current internal reporting systems to satisfy the guidelines.
17. Require an actuarial certification that the premium reductions available from one or more PRPs from an AIP, or from affiliated AIPs, are not unfairly discriminatory to producers not offered a premium reduction from the AIP or its affiliates, including the detailed basis for that determination; that only differences in direct delivery and service expenses, and not differences in losses or profit sharing with third parties, were considered; and that differences between PRPs from the AIP, or affiliated AIPs, are not unfairly discriminatory to producers. The PRP submission should then be subject to an expert review by an independent qualified actuary.
18. Require an offsetting evaluation of increase expenses from profit sharing or loss contingency payments, where any expense varies inversely with losses.
19. Require an offsetting evaluation of the increase in losses or other expenses, where any type of expense reduction from business under a PRP could create an incentive for an increase in losses or other expenses from other business of an AIP or its affiliates.
20. Where (18) or (19) applies, require an actuarial certification that all offsetting increases in expenses or losses of an AIP, and its affiliates, have been considered in evaluating the expense savings from the PRP.
21. Require disclosure to RMA of all arrangements for the AIP and its affiliates where crop insurance delivery costs can be influenced by other compensation arrangements.
22. Disapprove a PRP that depends on a reduction in agent compensation unless there is clear evidence and justification as to how the agents' costs are going to be reduced.
23. Develop a fair cost measurement standard based on a confidential review of the current operations and expense recording approaches used by AIPs, and require the AIP to submit details on how the AIP will comply with the cost measurement standard.
24. Require payment by the AIP of the costs to comply with standards, guidelines, or independent review procedures, as required by the RMA to verify the accuracy of the AIP's expense information.

The major responses to the Board's issues are focused on those PRP elements that could cause either short or long term problems with the crop insurance program. The report discusses the issues and the possible adverse impacts that could arise. However, the principal concern is whether the PRPs meet the intent of the Federal Crop Insurance Act. Based on our review of the information included in the Board issues and our analyses and responses to the Board's questions, we do not feel confident that this concern will be satisfied without a number of safeguards in place.

We recognize that there are many challenges associated with meeting the requirements of the Act. Our responses are directed at solving these challenges and it seems possible that the major issues can be resolved.

The Research Report section discusses each issue in detail. We realize that a full resolution of every issue may not be possible given the practical constraints associated with this program and the available data. However, we hope that the key recommendations contained in this review will help the Board address the major issues.

II. Introduction & Background

This report has been prepared as stipulated in the Blanket Purchase Agreement (BPA) 45-RMA1-4-0039 for Call Order # RMA-05-0002, regarding the expert review of the Premium Reduction Plan Issues. Section 505(e) of the Federal Crop Insurance Act (7 U.S.C 1501(e)) requires the FCIC Board of Directors to establish procedures under which any policy or plan of insurance, as well as any related material or modification of such a policy or plan of insurance, submitted to the Board be subject to independent review by persons experienced as actuaries or in underwriting.

This report presents Deloitte Consulting's methodology and research report supporting our recommendation provided in the Executive Summary section of this report. Our report addresses the review of the FCIC Board issues concerning "Premium Reduction Plans (PRP)" according to the FCIC's Procedure for The Submission and Review of New and Revised Crop Insurance Policies, as approved 12/12/2001. The issues are detailed in the FCIC Board Memorandum No. 785,
Resolution to Approve Reviewers and Alternates, Approve the Task Order Statement of Work for the Review of Premium Reduction Plan Issues, and Approve Execution of the Contract, Adopted by the FCIC Board of Directors on 11/19/04.

III. Distribution and Limitations

This report is prepared for the use of the FCIC Board of Directors. A copy of this report may also be provided to others, provided that the report is distributed in its entirety. *No other use or distribution of this report is authorized without written consent.* This report has been prepared for use by individuals who have a high degree of technical competence in crop insurance matters. This report should be considered in its entirety in order to have a thorough understanding of the conclusions and recommendations in the report. Deloitte Consulting assumes no responsibility for any loss or damage from the use of this report, or reliance upon the recommendations in this report, except as described herein.

Our engagement is to review the issues as described in the Task Order Statement of Work for Actuarial and Underwriting Reviews of Premium Reduction Plan Issues for the FCIC Board of Directors, as documented. in a written document. We have not conducted any original research for this report. We have relied on the expertise and market knowledge of our review team, as well as, publicly available industry documents, academic research and texts, and generally accepted industry standards.

IV. Research Report

Description of the Methodology

This report is an expert review of the issues facing the Federal Crop Insurance Corporation (FCIC) related to a specific premium plan applicable to crop insurance. Deloitte Consulting was engaged to perform this review in our capacity as experienced actuaries, underwriters, insurance professionals and accounting professionals. Our approach to this review has been to review the issues and answer the required questions included in the work order where we have the applicable experience or knowledge. Due to limited timing, we have not performed any field studies or surveys of Approved Insurance Providers (AIP), crop insurance agents, or insured crop producers.

Approach

Deloitte Consulting has conducted a review of the issues in order to assist the Board in its consideration of rulemaking for the approval of individual Premium Reduction Plan (PRP) submissions and procedures for overseeing same. Our analyses included a review of the description of work and specific issues described in the Task Order Statement of Work to determine whether all of the task items for this expert review were fulfilled properly.

Discussion of the Issues

The following responses address the specific required expert review questions. We have generally addressed them in the order presented in the statement of work.

1. *The impact of premium reduction plans on producers' likely use of insurance as a risk management tool. The impact analysis may include review of literature on the elasticity of demand of crop insurance, recent experiences where rates may have been cut, and an estimate of the impact of a 10% cut in farmers premium, among other things. Recent experience has generally shown that as producers' premium costs are reduced, the additional funds available to producers have been allocated to enhancing the risk protection purchased by producers, and crop insurance program participation and coverage levels purchased increase.*

Our view is that the use of crop insurance, as a risk management tool, is encouraged when the producer costs are understood by the producer to create a reasonable chance of a favorable economic outcome in the event of loss. The detailed knowledge of the cost benefit of the insurance purchasing decision would tend to encourage greater participation by producers in the Crop Insurance Program. Higher coverage levels increase the chance that a producer will benefit from their insurance purchase. Additionally, producers will tend to purchase greater amounts of coverage to the extent that it is affordable and they perceive a reasonable chance of an improvement in their economic result, given their perception of the risks of economic loss. We have not seen any relevant studies to indicate the behavior of producers in a premium reduction scenario, as suggested above. However, our collective experience suggests that insureds will make decisions regarding insurance purchases that are frequently at odds with the pure economics, but are often related to personal preferences regarding risk aversion and the level of understanding as to how insurance works. Another positive result is from growth in the use of insurance as a risk management tool is a reduction in adverse selection. This result stems from increasing the number of producers purchasing insurance and increasing the amount of insurance purchased. Insurance becomes more affordable when the risk of loss is spread across many insureds instead of only among those insureds who insure the higher risks. This benefits both the AIPs (better underwriting results) and the producers (reduced cost of coverage for producers). We suggest not placing an over-reliance on measuring the potential impact of a PRP with respect to the potential incentives for producers to enhance their risk protection through insurance. We do not see any apparent negative aspects that would cause producers to purchase less insurance. However, it may be relevant to collect data from the AIP related to changes in insurance coverage levels or plans of insurance under a PRP as a tracking tool.

a. *The Board wants to know the extent to which reduced crop insurance premiums will assist or induce producers to increase the use, level of coverage and, therefore, the effectiveness of Federal crop insurance as a risk management tool, or otherwise strengthen the economic stability and financial capacity of agricultural producers.*
b. *The Board also wants to know if such changes will likely contribute to decrease the need for future ad-hoc agricultural disaster assistance.*

These two issues suggest a broader question. What data is needed to gauge the relationship between premium levels, use of insurance, and effectiveness of insurance as a risk management tool? To the best of our knowledge, existing data is generally insufficient to address these issues. However, it should be possible to deploy specific survey techniques to study these relationships and assist the Board in considering these issues both before implementation of a PRP and on an ongoing basis.

2. *The impact that premium reduction plans might have on the delivery system for crop insurance. There have been applications that offer premium reduction plans in all states for all plans of insurance, in selected states or for selected plans of insurance; that offer different reductions between and within a state; that offer reductions based on the timing of certain events; that offer reductions based on reduced agents commissions, reduced loss adjustment expenses, and reduced profits from the administrative and operating expense reimbursement. The SRA specifically requires approved insurance providers to use only licensed agents and obligates the provider to ensure that agents and loss adjusters are properly trained to sell and service policies. It also requires that approved insurance providers demonstrate financial and operational ability and capacity to meet their obligations under the SRA that include the selling of policies to all farmers without discrimination, accurate representation of FCIC products and policies and the accurate, timely evaluation and payment of claims.*

In general, there is considerable competition in most lines of property/casualty insurance and extensive flexibility in policy coverage, underwriting standards and selection, rating and pricing approaches, and commission levels that may fluctuate based upon capital capacity and claims experience over time. This is in contrast to the current functioning of the Federal Crop Insurance programs which, basically, do not allow such flexibility, and therefore competitive factors in the Federal Crop Insurance programs are diminished. The Premium Reduction Plan (PRP) allows flexibility in only one area, reduced pricing based on lower estimated expenses. It appears that in the PRP submissions, each AIP is attempting to introduce more of the factors that currently enable competition on other lines of property/casualty insurance. We do not believe that the introduction, and consideration, of such marketplace factors would adversely impact the proper delivery or servicing of crop insurance, or the appropriate adjustment of claims. Each AIP has a clear incentive to meet the SRA requirements and a PRP would not be expected to have a significant negative impact on service to producers. However, some of the PRP design issues are not consistent with the RMA's principles that a PRP be fully justified based on verifiable expense savings from efficiencies and that there is no resultant unfair discrimination.

It appears that the RMA may have expected a PRP to be based on a specific and identifiable efficiency, e.g., internet sales. However, the PRP examples provided in the statement of work indicate that AIPs are claiming that expenses reductions may be realized for certain states, certain plans of insurance, certain agent commissions, or for efficiencies that may be difficult to identify, measure or verify. Some of these proposed expense reductions could indicate that an AIP might want to offer a lower premium to attract new insureds who are currently insured by another AIP, or may want to prevent their current insureds from changing to another AIP because of a lower premium. The same logic could be applied to an agent who may want to be able to offer a lower premium to attract new insureds who are currently insured through another agent, or prevent losing an insured to a competing agent. To the extent that this explanation is a major motivation for the proposed PRPs, the proposed expense reductions would not come from true efficiencies, but rather from reductions in operating profits (or increased operating losses) currently earned by AIPs and agents. Such reduced profits (or increased losses) could provide a significant incentive for AIPs and agents to become more efficient due to competitive pressures. However, it does not appear that the intent of allowing PRPs was to open up premiums to competitive pressures that might result in expense efficiencies. Rather, the PRP materials provided suggest that AIPs would need to demonstrate how they can achieve expense savings through efficiencies, and that such expense savings can be validated. The proprietary nature of the each AIP's cost structure, and the inherence advantage its efficiencies may afford, would lead AIPs to be reluctant to publicize this information. The sources of efficiencies are essentially "trade secrets" of each AIP. "Validation" tests may prove difficult to effect as AIPs will endeavor to secure their competitive advantages from other AIPs.

a. *The Board wants to know what impacts each of these types of premium reduction plans will have on the agent work force, on agent training, on claims adjustment, on approved insurance providers, on the crop insurance marketplace, and on service to producers. The Board wants to know what those impacts will be, and how to detect and mitigate potential problems.*

The types of PRPs identified are:

- reductions based on the timing of certain events,
- reduced agents commissions,
- reduced loss adjustment expenses, and
- reduced profits from the administrative and operating expense reimbursement.

None of these PRP types refers to whether there is, in fact, any efficiency that will be attained or how it will be measured. All of these PRP types simply reduce the compensation received from the A&O subsidy to reimburse the AIP for its expenses. There does not appear to an explanation as to why agents would accept a reduced commission, how loss adjustment services can be performed for reduced costs. A reduction based on the timing of certain events is difficult to assess without understanding the nature of the events and the timing implications. A PRP from reduced profits associated with the A&O subsidy seems to be justified on the basis that the AIP is already operating more efficiently than what the A&O subsidy provides. However, this presumes that the AIP's operating expenses are not somehow being subsidized already by other existing compensating arrangements. For example, the parent company or an affiliated company may not be allocating full costs to the AIP; or an AIP may have existing agreements with its underwriting managers (or program administrators) to pay lower up-front agent commissions, but pay significant profit sharing on the underwriting gains.

Determining what, if any, adverse impacts there may be on the agency force, agent training, loss adjustment services, the service to producers, etc. is difficult to predict because there are potentially endless variations on how agents and AIPs might operate and how services could be delivered. Assuming no significant improvements in agent or AIP operations, and no significant improvements in service delivery, reduced compensation to the AIP could result in unacceptable deteriorations in service. However, the AIPs and agents should be well aware of their service responsibilities under the RMA's requirements and the SRA, and serious service deterioration resulting from reduced compensation would seem unlikely from experienced agents or a well established AIP. There is an inherent disincentive to AIPs or agents reducing services to insureds. Market forces run in opposition to such reduction in service. AIPs who compromise service to insureds will lose customers and revenue (profits).

One suggestion for mitigating potential problems would be to require an attestation signed by a responsible officer of the AIP, such the president or chief underwriting officer. Such attestation could be structured to address the Board's concerns and provide a basis for validation or audit that the AIP has sufficient controls in place to prevent, detect, remedy or mitigate the issues raised by the Board. This type of process and attestation is becoming more prevalent and familiar to company managements, as a result of Sarbanes-Oxley laws related to financial audits of public companies. The NAIC is currently considering a similar process for insurance companies to follow with respect to statutory financial statements.

b. *The Board also wants to know whether all approved insurance providers: 1) should be required to offer their premium reduction plan for all states and plans of insurance where they write; 2) should be allowed to limit their premium reduction plan to a limited number of states; or 3) should be allowed to pick the plans of insurance for which a premium reduction plan will be offered.*

By allowing AIPs to use PRPs for limited number of states or selected plans of insurance, RMA would be encouraging AIPs to see how a PRP works in practice before taking a significant risk of applying the PRP across all states and all plans of insurance. However, this flexibility also might encourage use of this flexibility as a competitive pricing tool for an AIP to use to primarily attract new insurance only from certain groups or types of producers, or to try to retain the insurance from certain groups or types of producers who are being offered lower premiums from another AIP. Such competitive behavior could also be motivated by the AIP's anticipated increase in underwriting gains (lower losses) from PRP business rather than simply from lower expenses.

Based on our understanding and interpretation of the Board's authority to approve PRPs, and the principles articulated in the statement of work, we suggest that rulemaking be established that:

(1) An AIP be required to offer its PRP in all states and for all plans of insurance, unless the AIP can demonstrate that the underlying expense efficiencies have been significantly different by state or by plan of insurance. Such differences would need to be verifiable through an independent review or based on expense data reported to the RMA. Also, the AIP would be required to demonstrate, with an analysis of expense experience data, that the PRP is not unfairly discriminatory between PRP and non-PRP insureds.

(2) An AIP be allowed to offer a PRP in a limited number of states on a pilot basis for a limited pilot period. Such a pilot PRP should have a limited authorization in terms of total PRP premiums and the period of availability, not to exceed 3 crop years unless approved by the FCIC for an extension. The AIP is required to report expense data separately for PRP and non-PRP business as required by the RMA. An AIP is not permitted to have more than one pilot PRP available for any crop year.

(3) An AIP be allowed to offer a PRP for one or more selected plans of insurance on a pilot basis for a limited pilot period. Such a pilot PRP should have a limited authorization in terms of total PRP premiums and the period of availability, not to exceed 3 crop years unless approved by the FCIC for an extension. The AIP is required to report expense data separately for PRP and non-PRP business as required by the RMA. An AIP is not permitted to have more than one pilot PRP available for any crop year.

c. If a limited number of states should be allowed, the Board wants to know whether RMA or the approved insurance provider should be allowed to select the states and what criteria should be used for the selection.

The criteria should be based on the actual cost efficiencies as described in our response to issue 2)b(1) above, or on a pilot basis based on expected cost efficiencies in accordance with our response to issue 2)b(2) above. Operating expenses may vary materially from state to state. It is reasonable to allow AIPs to reflect these differences in state specific PRPs. This concept is consistent with other property and casualty lines of insurance available to producers. The AIP should be able to select the states, subject to RMA review and acceptance.

3. *The impact of premium reduction plans on small, minority and limited resource farmers. The SRA specifically requires that all approved insurance providers service equally all farmers applying for insurance, including small, minority and limited resource farmers. However, concerns have been raised that the application of cost efficiencies in premium reduction plans, including the reduction of agent commissions, could result in a reduction in service to, or limited access to insurance for, certain small, minority and limited resource farmers. The Board wants to know whether the premium reduction plans, including those referred to in the previous question, are likely to result in a reduction in service to small, minority and limited resource farmers, what reductions in service, if any, are likely to occur, and how RMA can ensure that small, minority and limited resource farmers will not be disadvantaged by premium reduction plans.*

Under the current A&O reimbursement, the A&O subsidy that AIPs receive is a percentage of premiums. Consequently, any producer whose premium is small, including small, minority and limited resources farmers, does not generate many dollars of A&O subsidy. However, the costs to the AIP and agent to provide the needed insurance advice and service in their purchase of crop insurance could easily exceed the A&O subsidy from such small policies. To the extent that a PRP is based on cost efficiencies, such as through technology automation or process improvement, where the routine and simple insurance information can be communicated to small premium policyholder at a lower cost to the AIP and agent, then such a PRP would not provide any disadvantage to the small, minority and limited resources farmers. However, if a PRP is based on cost efficiencies from producers who pay large amounts of premium, such cost efficiencies may simply be the recognition that the costs to service a producer with large premiums is significantly less that the amount the AIP receives in A&O subsidy, or the amount that the agent receives in commissions.

Unfortunately, there is no simple answer to this issue. A thorough solution would need to review the current A&O reimbursement/subsidy structure to consider paying a higher percentage A&O subsidy to AIPs for producers with small premiums and a smaller percentage A&O subsidy to AIPs for producers with large premiums. A PRP based on cost efficiencies that are derived primarily from producers who pay large premiums would exacerbate this issue. The potential mismatch of service costs with A&O subsidy received as percentage of premiums does not currently appear to be a major problem in creating a disadvantage to small, including small, minority and limited resources farmers. AIPs should clearly understand their obligations under the SRA to service such farmers. If the PRP applies to some carefully defined group of producers with predominantly large premiums, while the remaining producers have predominantly small premiums, then such a PRP might be considered to be unfairly discriminatory based on size. In order to prevent or detect such unacceptable plans, RMA could require the AIP to report producer count, expense and premium data for PRP vs. non-PRP insureds and additional data that profiles the premium size distribution of producer premiums for PRP vs. non-PRP insureds, including an analysis that demonstrates how their PRP was not unfairly discriminatory.

4. *The impact of the requirement in the current procedures that a premium reduction plan be initially offered on a limited basis and later expanded to all states where the approved insurance provider operates. The approved insurance provider first approved to offer a premium reduction plan was a new provider that wrote in a limited number of states. The Board required the approved insurance provider to phase in the implementation of its premium reduction plan to ensure it could achieve the efficiencies claimed in the application and comply with the other requirements of the crop insurance program. Subsequently, the Board required the approved insurance provider to offer the premium reduction plan in all states in which it operated which currently numbers 15. Many of the approved insurance providers who have applied for the 2005 crop year have been in the program for years and some operate in a substantially larger number of states than the current approved insurance provider that offers a premium reduction plan.*

    a. *Thus, the Board wants to know whether it is necessary to have established approved insurance providers phase in their premium reduction plans.*

We do not believe that it would be necessary to phase in PRPs, but an AIP might wish to phase in a new PRP in order to reduce the risks associated with a new plan. Such a phase in could be similar to a pilot basis, as described in our responses to issue 2)b. Alternatively, an AIP could provide a planned phase-in based on the number of crop years that the plan has been in place, where certain states could be designated to be added each year, or upon reaching stated annual PRP premium thresholds or expense savings thresholds.

b. If a phase in is necessary, the Board wants to know what should be the recommended number of states in the first year and for how many years it should take to completely phase in the premium reduction plan.

The initial number of states to include in a phase in plan will depend on volume. The initial number of states should have sufficient expected premium volume to allow validation of the expected expense reductions. As with our recommendations for the offering a PRP on a pilot basis, we recommend that a phase-in should be completed within no longer than 3 years.

c. If the purpose of the phase in is to allow a test of the premium reduction plan to ensure that it meets all the requirements, the Board also wants to know whether it should permit changes to a premium reduction during the phase in period.

Changes during a phase-in period should be treated the same as if the PRP was being withdrawn and a new PRP was being submitted to replace it. Consequently, the information, data and analyses should support any changes being requested. The processed can be streamlined to the extent that portions of the original PRP submission remain unchanged and unaffected, and the change request attests that the original submission is still valid, except to the extent changed in the PRP change submission.

5. *The impact of allowing complex premium reduction plans. Two of the guiding principles supporting the current premium reduction plan procedures are: (1) there must be sufficient documentation to demonstrate the efficiency, the costs of delivery of the program prior to the implementation of the efficiency and the costs of delivery of the program after implementation of the efficiency; and (2) that the efficiencies and the costs before and after the implementation of the efficiency are readily verifiable. Several of the current premium*

reduction plan applications introduce complicating concepts as stated in question 2. Given these guiding principles, please respond to the following:

a. Approved insurance providers currently submit most expense information to RMA on an aggregate basis for all crop insurance policies they deliver in their Plan of Operation. Some expense reports are on an actual cost basis; others are on a projected cost basis. Further, certain of the expense reports are on a calendar year basis and others are on a reinsurance year basis. Thus, since the administrative and operating expense reimbursement is provided on reinsurance year basis, the Board wants to know how RMA can verify the approved insurance provider's are properly restating costs that were originally presented on a calendar year basis to a reinsurance year basis..

For AIPs who submit expense data on a calendar year basis, the AIP should be required to submit a reconciliation of the reinsurance year expense data to the calendar year expense data in its annual (calendar year) statutory-basis expenses reported in the Insurance Expense Exhibit for the Multiple Peril Crop Insurance Line of Business (line 2.2). Such reconciliation of expense data should be subject to independent verification, if requested by RMA. RMA should have the AIP certify the accuracy and reasonableness of the information. Where expenses are on a projected basis, the AIP should be required to reconcile the projected vs. actual expenses on an annual basis, once the actual data are available. Such reconciliations may involve certain cost allocations or estimates of apportioned costs. Sufficient details and supporting materials should be maintained by the AIP for an independent verification of the allocation or estimating procedures. RMA can either test the information provided itself; or the RMA can require that the AIP hire an independent accountant to perform agreed upon procedures related to the information provided. RMA would have to determine exactly what procedures need to be performed and determine if those procedures can be performed as part of the accountant's professional guidelines. The specific agreed upon procedures should be reviewed by more than one accounting firm to confirm that such procedures meet those professional guidelines.

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b. *Some of the premium reduction plan applications have different means to attain the efficiency (e.g., changes in computer systems, reductions in agent commissions, reductions in loss adjustment expenses, Internet sales, earlier sales, etc.) The Board also wants to know how RMA can accurately determine and verify the cost reduction attributable to each type of efficiency.*

Some cost efficiencies may be easily identified and verified, such as reductions in agent commissions. Others may be very difficult to determine accurately, such as savings from computer applications that automate certain manual processes. However, it may not be reasonable to require an AIP to change it cost accounting systems solely for dividing costs into multiple efficiency-type categories under a PRP plan. Once cost efficiencies are implemented, it may not be possible to determine the amount of "reduction" attributable to an individual type of efficiency unless a particular type of efficiency is rather simple, such as a lower percent commission paid to agents. Furthermore, an AIP that already is more efficient than the A&O reimbursement provides would not have any benchmark to compare to other than the amount of A&O subsidy. Consequently, we do not believe that it is possible for the RMA to accurately determine and verify the cost reduction attributable to each type of efficiency.

As discussed above, RMA could have the AIP provide the details of its cost reduction plan along with the actual results. RMA should have the AIP certify the accuracy and reasonableness of the plan and the actual results. RMA can then either test the actual information provided itself; or the RMA can require that the AIP hire an independent accountant to perform the agreed upon procedures. The actual results should be reconciled to the AIP's expenses reported in Insurance Expense Exhibit (IEE) for the Multiple Peril Crop Insurance Line of Business (line 2.2) filed with state insurance departments. An insurer's Annual Statement is subject to audit by state insurance departments (every 2 to 3 years) and by an independent certified accountant annually. The IEE is not subject to audit, but it must reconcile to the Annual Statement. Note, that the insurance department or certified accountant's audits do not typically address expense allocation reporting.

c. *Several of the approved insurance providers also write other lines of business, such as property and casualty insurance. Therefore, there must be an allocation of costs between these lines of business. The Board wants to know how such costs should be allocated, and how RMA can detect and prevent improper allocation of costs between premium reduction plans and other activities of the approved insurance provider.*

There are certain guidelines and common accounting practices that insurance companies generally follow for their financial reporting requirements to state insurance regulators. However, those guidelines and practices only address allocations of certain expenses to lines of business, such as workers compensation, homeowners, farmowners, other liability, etc. The level of detail involved at the line of business level does not breakdown expenses that might be useful to RMA in detecting improper allocations of costs between PRPs and other AIP activities. However, each AIP currently reports its total annual expenses associated with the federal crop insurance program to RMA. Consequently, each AIP would currently have established procedures for the allocation of costs between lines of business, down to the level required under the SRA. In general, an AIP would allocate its expenses according to the state regulatory accounting guidance for regulatory reporting purposes, which prescribes attributing expenses based on direct costs, where possible, and then remaining costs can be allocated based on direct costs, salaries and related costs, number of policies, premium volume, loss volume, time studies, special cost studies, etc.[1] The textbook, "Property-Casualty Insurance Accounting", published by the Insurance Accounting & Systems Association (IASA), discusses expense allocation for NAIC reporting to state insurance regulators, and for management reporting. A distinction is made that NAIC reporting emphasizes financial condition, liquidity and solvency, while management reporting has a broader perspective to support management decision-making processes. In general, the NAIC reporting in too broad to capture the level of detail needed to verify an AIP's expense savings for a PRP. However, the accounting principles involved can be used by an AIP and then reconciled to the NAIC level of reporting.

[1] Property-Casualty Insurance Accounting, 8th Edition, 2003, Insurance Accounting & Systems Association (IASA), pages 8-5 through 8-12.

If this is a major concern of the Board, then we would recommend that the RMA develop and publish guidelines for the allocation of expenses to an AIP's insurance business under the federal crop insurance program business, and require an AIP to submit its detailed expense allocation procedures, with examples, for how the AIP allocates its expenses to this business.

The AIP should be able to provide detail supporting its allocation of costs by line of business by state. It should be able to provide this same support on an annual basis. It is important that the allocation reconciles to the annual statement filed with state insurance departments. RMA can either perform procedures itself on this information or have an independent accountant perform agreed upon procedures.

d. Several of the applications received for a premium reduction plan state the plan will only be offered in certain states. This will require an allocation of costs within the crop insurance business. The Board wants to know how such costs should be allocated and how RMA can detect and prevent improper allocation of costs between states

The main issue seems to be how each AIP would allocate expenses between PRP vs. non-PRP crop insurance business, or between different PRPs, if an AIP maintains multiple PRPs. It is not clear how each AIP would approach the allocation of expenses down to a plan level, other than its direct expenses attributable to a PRP, such as different agent commissions. If this is a major concern of the Board, then we would recommend that the RMA develop and publish guidelines for the allocation of expenses to a PRP, and require an AIP to submit its detailed expense allocation procedures, with examples, for how the AIP proposes to allocate its expenses to the PRP.

e. Once the costs have been allocated, the Board wants to know how RMA can verify that the same allocation of costs was used to determine the total costs before the application of the efficiency, the amount of the efficiency, and the total costs after application of the efficiency.

In order for the RMA to verify the allocation of costs, we would recommend that the RMA establish guidelines for the allocation of costs and that each AIP submit their detailed expense allocation procedures, with examples, for how the AIP allocates its expenses. With this information, an independent accountant could then perform agreed upon procedures to verify that the AIP's allocations of costs were performed in accordance with the AIP's submitted expense procedures. An independent accountant would be expected to report that no exceptions were discovered in the review, related to the actual allocation of costs compared to the AIP's stated procedures. If there exceptions were found, they the accountant would report them. We do not believe it is necessary to verify or test the allocation of costs before the application of the efficiency, or the amount of the efficiency, unless the AIP's cost allocations or their procedures are based on the costs before the application of the efficiency or on the amount of the efficiency.

f. The Board wants know whether there is a fair and equitable system of cost identification that can be applied to all approved insurance providers offering premium reduction plans.

The core of this issue is whether objective standards can be developed to determine a fair and equitable cost identification system which is reasonable to impose on all AIPs offering PRPs. The establishment of such standards or guidelines, in advance, is possible, but somewhat difficult since current practices can be quite varied. We recommend that the RMA establish guidelines for cost identification and allocation, and then require the AIP to submit its PRP with details on how the AIP will meet the guidelines. The PRP submission should then be subject to an expert review by a qualified expert.

g. If there is such a fair and equitable system, the Board wants to know what it would look like and how it should be applied.

Cost accounting guidelines could be developed using the approaches described in the IASA Property-Casualty Insurance Accounting textbook. However, each AIP may need to adapt its current internal reporting systems to be consistent with the guidelines. We recommend some flexibility in how an AIP proposes to satisfy the guidelines due to the existing differences in internal expense reporting systems among AIPs.

h. There is also a requirement that the premium reduction be offered in the same place where the efficiency was derived. Given these complex premium reduction plans, the Board wants to know how RMA can determine and verify that the efficiencies correspond to the plans of insurance, states, or areas where the premium reduction plan is to be offered.

Annually, the AIP should be required to provide cost allocation information in the same format as provided for the initial PRP submission. This should be reconciled to expenses reported in Insurance Expense Exhibit for the Multiple Peril Crop Insurance Line of Business (line 2.2) filed annually with state insurance departments. Either RMA or an independent accountant can test the reasonableness and consistency of the information. Any other procedures that RMA deems reasonable can be performed as well.

6. *The impact of allowing an approved insurance provider to offer a premium reduction plan through an affiliated entity while not offering it through other affiliated entities. Some premium reduction plan applications have requested that the approved insurance provider be allowed to divide into two entities, one that will offer a premium reduction plan and one that will not. Other applications request that agents be allowed to offer a premium reduction only to selected producers and not to others insured with the same approved insurance provider.*

The use of different PRPs among different affiliated AIPs, or the creation of entities within an AIP in order to be able to offer different PRPs, is very similar to a normal property & casualty business strategy to segment the insurance market according to the profitability and growth goals of the insurer. Such arrangements introduce price competition into the market and can be based on expected expense differences, expected differences in underwriting profits (insured losses), or both. Based our current understanding of the crop insurance market, some AIPs already use various commission incentives to individual agents, structured based on state, crop, county, plan of insurance, etc., to improve the AIP's profitability of its crop insurance business. The difference with such proposed PRP arrangements versus the current differences in agent commissions is that the premium paid by similar insureds could be affected. To the extent that certain types or groups of insureds can be predictably more profitable than others, the AIPs will have an incentive to compete for those insureds. With the introduction of PRPs, such competition will affect the premiums paid by individual insureds. Whether such differences would be considered unfairly discriminatory, depends on what standards are applied to judge fairness in the pricing discrimination. In other lines of property & casualty insurance, the issue of unfair discrimination has been a very frequently debated issue for insurance regulators who are responsible for regulating premium rates for some lines of insurance. In general, the principles applied to evaluate fairness in insurance premium differences have focused on differences in the expected costs of providing insurance, including both expenses and insured losses. Expense differences in property & casualty insurance are quite minor compared to differences in losses. This is also true for crop insurance.

It appears that the intent of the PRP option is to allow some price competition, but only based on expense differences that can be demonstrated to be not unfairly discriminatory, and not based on differences in underwriting profitability (insured losses). Consequently, the Board would need to establish effective measures to regulate PRPs regarding both concerns. We believe that the regulation of expense differences separately from underwriting profits is complicated by the various different business practices of AIPs and where the incentive for expense differences is significantly influenced by differences in underwriting profits. Whether a premium rate is unfairly discriminatory depends on the costs being considered and how insureds will be charged different premium rates. Since the intent of PRPs appears to be based on expense differences alone, the determination of unfair discrimination would need to be made on a case by case basis. We believe that current actuarial principles, standards and common practices can be applied to attain the desired prevention against unfair discrimination. In order for a PRP to be acceptable to the RMA, we recommend that each PRP submission contain an actuarial certification (statement of actuarial opinion) that the premium reductions available from one or more PRPs from an AIP, or from affiliated AIPs, are not unfairly discriminatory to producers not offered a premium reduction from the AIP or its affiliates. The actuarial certification should include (1) the detailed basis for that determination, (2) that only differences in direct delivery and service expenses, and not differences in losses or profit sharing with third parties, were considered, and (3) that differences between PRPs from the AIP, or affiliated AIPs, are not unfairly discriminatory to producers. The PRP submission should then be subject to an expert review by an independent qualified actuary.

a. The *Board wants to know if such arrangements could result in unfair discrimination against certain producers*.

Yes, they could, particularly if such arrangements are used on a selective basis to individual producers. However, state insurance regulators currently deal with market conduct issues which could help to prevent or discourage major issues. It should also be noted that what might be considered unfair discrimination on the basis of expenses differences may not be considered unfair discrimination when both expenses and losses are considered. See further explanations above.

b. The Board wants to know if such arrangements could compromise the integrity of the crop insurance program.

We do not believe that such arrangements are likely to seriously compromise the crop insurance program integrity. Such arrangements have existed for decades in property & casualty insurance without causing major disruptions to the insurance marketplace.

c. The Board wants to know if such arrangements could allow the improper allocation of costs among affiliated entities to the detriment of some producers and to the crop insurance program in general

Yes, they could allow the improper allocations of expenses, particularly if such arrangements create pricing tiers though the use of different a PRP for each affiliated entity that is structured to improve the AIP's profitability from both losses and expenses. Whether the impact might be considered detrimental to some producers is unclear. We do not believe that such arrangements are likely to be seriously detrimental to the crop insurance program in general.

d. If such results would occur, the Board also wants to know how RMA could detect and prevent them.

The measures suggested in this review are recommended as key elements to effectively detect and prevent improper expense allocations detrimental to producers. In particular, we refer to requiring the AIP to submit its detailed expense allocation procedures, to certify the accuracy and reasonableness of reported information, and to obtain an independent accountant's review.

7. The impact of changes in agent or other service providers' compensation included in premium reduction plan applications on the integrity of premium reduction plans and on the integrity of the crop insurance delivery system. RMA has been told that reductions in agent commissions used to generate cost savings in a premium reduction plan may be offset by agents receiving a greater share of the profits from crop insurance policies that they sell and service, or a share of the total crop insurance profits of the approved insurance provider. Such approaches to agent compensation may be used to improperly classify true costs as profit sharing to shift or hide costs and misstate the claimed cost efficiencies of the approved insurance provider under a premium reduction plan.

We agree that when agent compensation is comprised of both a premium based commission and a profit sharing arrangement or contingent commission that is based on the AIP's actual or expected profits, then it can be very difficult to measure service delivery costs or to identify cost efficiencies. For other lines of property and casualty insurance, such complex agent or broker compensation arrangements are fairly common and have been in existence for decades. Such complex compensation arrangements can mix lines of business, states, plans of insurance, etc. and have various provisions, such as limiting losses charged against the profit sharing or providing increase compensation for growth in certain business or class of insureds.

Another complicating business practice is the delivery of insurance through program administrators. Sometimes referred to as managing general agents or underwriting managers, these administrators provide a wide range of insurance services from the direct sale of insurance to the public, loss adjustment services, policy issuance and recordkeeping, certain insurance accounting functions, arranging reinsurance, managing and paying insurance agents, etc. Sometimes these administrators handle many of the functions that might be otherwise handled by insurance company employees. Typical compensation to the administrator is based on a percent of premiums and usually includes some profit sharing. These administrators are not regulated as insurance companies and typically do not have the accounting procedures that insurance companies do. In some cases there can be some ownership interest in the administrator by one or more insurance companies. There are also cases where an administrator can have some ownership in an insurance company. Administrators are not typically public companies and may not have an independent accounting audit of their financial statements.

We understand that administrators are used in the crop insurance business and have been active in this business for many years. We have not researched how the compensation paid to administrators by AIPs is recorded in the insurance company's financial reports. However, we believe that reporting such compensation as commissions and brokerage, contingent commissions, or allowances to managers and agents would comply with statutory insurance accounting requirements. We understand that such administrators may receive most or all of the A&O subsidy and may also receive ceding commissions from third party private reinsurers. In those cases where an administrator is used, the AIP cannot determine service delivery costs in much detail unless provided by the administrator. Where the administrator is unaffiliated with the AIP, the AIP has no direct control over the expenses of the administrator. The AIP simply pays a percentage of the premium, or the A&O subsidy, to the administrator. In such cases, the cost savings under a PRP might only be part of the compensation agreement between the AIP and the administrator. Profit sharing could be another part of the compensation agreement.

Where an AIP uses one or more administrators for crop insurance business, the ability to determine or evaluate crop insurance delivery and service costs is problematic. The AIP may have only limited cost information from the administrator and little or control over the administrator's expenses.

a. *The Board wants to know what standards should be used to evaluate and determine which profit sharing compensation arrangements should and should not be considered part of the approved insurance provider's cost structure under a premium reduction plan.*

The existence of program administrators in the crop insurance business creates an obstacle to a proper evaluation of an AIP's cost structure. The existence of profit sharing arrangements further complicates the ability to separate differences in expenses from differences in underwriting profitability (insured losses). If the intent of the PRP option is to allow premium reductions only based on expense differences, and not based on differences in insured losses, then almost any profit sharing arrangement has the potential to undermine the measurement of expense savings from cost efficiencies. We realize that some may argue that profit sharing arrangements or contingent commissions are just another part of the expense of producing the insurance business. If the agent or program administrator is willing to accept a lower portion of compensation based on insurance premiums in return for potential higher compensation if losses are low, then that might be a rationale for claiming cost efficiencies. We do not believe that such an interpretation is consistent with the provisions of the Act which allows PRPs. Consequently, we recommend that:

(1) where any expense varies inversely with losses, such as with profit sharing arrangements, the evaluation of expense savings under a PRP will also require an offsetting evaluation of increase expenses from profit sharing or loss contingency payments;

(2) where any type of expense reduction from business under a PRP could create an incentive for an increase in losses or other expenses from other business of an AIP or its affiliates, the evaluation of expense savings under a PRP will also require an offsetting evaluation of the increase in losses or other expenses;

(3) where (1) or (2) applies, the PRP submission should include an actuarial certification (statement of actuarial opinion) that all offsetting increases in expenses or losses of an

AIP, and its affiliates, have been considered in evaluating the expense savings from the PRP.

b. The Board also wants to know how potential improper use of agent compensation arrangements, or compensation of other service providers, to misstate crop insurance delivery expenses can be detected and prevented, so that efficiencies are fairly reported and claimed.

Given the current business practices of AIPs, we believe that the detection and prevention of misstated crop insurance delivery costs, and the fair reporting of cost efficiencies, will require an actuarial certification, an accounting review and an expert review process. We recommend that where crop insurance delivery costs can be influenced by other compensation arrangements, all such arrangements must be disclosed for the AIP and its affiliates.

c. There are claims that reductions in agent compensation could result in agents no longer participating in the crop insurance program. The Board wants to know if and how such agent compensation changes that result from premium reduction plans could impact the long-term financial stability and capacity of the crop insurance delivery system and, thus, the availability of crop insurance to all agricultural producers, especially small, minority and limited resource farmers.

Under PRPs, AIPs will be motivated to reduce agent compensation as part of cost reductions in order to be able to attract or retain the more profitable business. However, those same AIPs will also be motivated to provide incentives to attract an agent's business to the AIP where that agent can provide more profitable business. It might make more sense to establish a standard for agent compensation that prohibits reductions in agent compensation as a basis for a PRP. While it may be possible to deliver and service insurance for producers at a lower cost, competitive pressures may also force some small agents out of business. In order to ensure that producers will have sufficient access to crop insurance, it may be necessary to have a separate compensation structure for agents that the AIP cannot reduce. We recommend that FCIC not approved a PRP to the extent that it depends on a reduction in agent compensation unless there is additional evidence and justification submitted as to how the agents' costs are going to be reduced.

8. *The need to determine and verify that an approved insurance provider's claimed efficiency will allow it to operate sufficiently below the administrative and operating expense reimbursement paid by FCIC to deliver the crop insurance program to cover the requested premium reduction. In their initial Plan of Operations for the 2005 reinsurance year and for prior years, some approved insurance providers have stated expenses that exceeded the administrative and operating expense reimbursement by a significant amount. In their applications for a premium reduction plan they have asserted that their expenses are now below the administrative and operating expense reimbursement, and can be reduced further if competitive pressures warrant further premium reductions. Many approved insurance providers have expressed the need for a fair standard that can be applied consistently to all approved insurance providers that would accurately measure the costs associated with the delivery of the crop insurance program for the approval and oversight of premium reduction plans. The Board wants to develop such a fair standard in the administration and oversight of premium reduction plans.*

    a. *The Board wants to know how such a fair standard should be designed and implemented.*

We believe that an objective standard can be developed for cost measurement which is fair and reasonable to impose on all AIPs offering PRPs. Such a standard could assist in ensuring that adequate controls are maintained over cost allocation and to ensure adequate service delivery to the producers. The establishment of such a standard, in advance, is recommended, along with implementation guidelines which recognize that current AIPs' practices can be quite varied. We recommend that the RMA require the AIP to submit its PRP with details on how the AIP will comply with the cost measurement standard. The cost measurement standard, and the associated implementation guidelines, will need to take into account that the AIPs' normal financial statements are not currently detailed enough to meet a crop insurance cost measurement standard. The RMA will have to rely on the AIP to generate the detailed expense allocation information. In order to increase the credibility and usefulness of the reported expense data, we recommend that the first year or two of reported data should be analyzed as part of an overall review of PRPs and to develop useful benchmarking information.

We recommend that the development of a fair cost measurement standard include a confidential review of the current operations and expense recording approaches used by AIPs. This review can be accomplished by interviews with AIPs and their staff who are familiar with current expense allocation procedures and expected methods to track expenses under PRPs. The standard should be drafted and exposed for discussion and written comments from the AIPs. Additional drafts may be necessary in order to arrive at a cost measurement standard acceptable to the FCIC and the AIPs. In the interim, we recommend that the AIPs submit their detailed expense allocation procedures, certify to the accuracy and reasonableness of reported information, and obtain an independent accountant's review.

b. The Board also wants to know whether FCIC, as part of the oversight of premium reduction plans, should require approved insurance providers to provide an independent certified accountant's audit of the approved insurance provider's expenses and claimed efficiencies related to its premium reduction plan and if such an audit would be an effective oversight tool.

As mentioned before, and recommended above, the FCIC can have an independent certified accountant perform certain agreed upon procedures as relates to AIPs and PRPs. This process can be an effective oversight tool provided that the cost measurement standard, implementation guidelines, and agreed upon procedures for the independent accountant review adequately address the issues identified by the Board. These agreed upon procedures can be developed in conjunction with, or as a result of, the drafting of the cost measurement standard and implementation guidelines specific to crop insurance.

c. The Board wants to know what other tools could be used to achieve the objective, if a certified accountant's audit is not thought to be an effective tool.

Additionally, the FCIC should require the AIP to provide a written statement attesting to the accuracy of any information provided to support the PRP. As the AIP will be required to provide regular objective information to support the continuation of the PRP, RMA personnel can also verify the accuracy of the information provided.

d. The Board also wants to know if the approved insurance provider should pay for the expense of such an audit.

The AIP is voluntarily applying for the PRP and should bear all the costs of supporting its compliance with the PRP during application and on an ongoing basis to validate the PRP financial performance. Therefore, the costs to comply with standards, guidelines, or independent review procedures, which are required by the RMA to verify the accuracy of the AIP's expense information, should be paid for by the AIP.

<u>Recommendations</u>

Deloitte Consulting recommends that the FCIC:

1. Conduct a scientific survey of producers and agents, specifically to gauge the relationships that the Board is most interested in, to obtain useful and objective information for evaluating the effectiveness of crop insurance as a risk management tool.
2. Require an attestation signed by a responsible officer of the AIP, such the president or chief underwriting officer, that the AIP has sufficient controls in place to prevent, detect, remedy or mitigate the negative impacts from the submitted premium reduction plans could have on the agent work force, on agent training, on claims adjustment, on approved insurance providers, on the crop insurance marketplace, and on service to producers.
3. Require an AIP to offer its PRP in all states and for all plans of insurance, unless the AIP can demonstrate that the underlying expense efficiencies have been significantly different by state or by plan of insurance, as verified through an independent review or based on expense data reported to the RMA; and to demonstrate, with an analysis

of expense experience data, that the PRP is not unfairly discriminatory between PRP and non-PRP insureds.

4. Allow an AIP to offer a PRP in a limited number of states, or for one or more selected plans of insurance, on a pilot basis for a limited pilot period, provided that the AIP does not have more than one pilot PRP available for any crop year.
5. Require the AIP to report expense data to the RMS separately for PRP and non-PRP business.
6. Allow the AIP to select the states for a PRP, based on state differences in operating expenses, subject to RMA review and acceptance.
7. Review the current A&O reimbursement/subsidy structure to consider paying a higher percentage A&O subsidy to AIPs for producers with small premiums and a smaller percentage A&O subsidy to AIPs for producers with large premiums.
8. Require the AIP to report data for PRP vs. non-PRP insureds that profiles the premium size distribution of producer premiums for PRP vs. non-PRP insureds, including an analysis that demonstrates how their PRP was not unfairly discriminatory.
9. Allow, but do not require, the phase in of a PRP, similar to a pilot basis.
10. Require a pilot or phase-in be completed within no longer than 3 years.
11. Treat changes during a phase-in period the same as if the PRP was being withdrawn and a new PRP was being submitted to replace it.
12. Require the AIP to submit a reconciliation of reinsurance year expense data to a calendar year basis and reconcile to expense data in the Insurance Expense Exhibit for the Multiple Peril Crop Insurance Line of Business (line 2.2), subject to independent verification, if requested by RMA.
13. Require the AIP to attest to the accuracy and reasonableness of the expense information submitted to the RMA.
14. If the RMA cannot test the expense information provided by the AIP to the RMA, require the AIP to hire an independent accountant to perform agreed upon procedures related to the expense information. The specific agreed upon procedures should be reviewed by more than one accounting firm to confirm that such procedures meet their professional guidelines.

15. Develop guidelines for the identification of costs and the allocation of expenses to an AIP's insurance business under the federal crop insurance program business, and to a PRP. Require an AIP to submit its detailed expense cost identification and allocation procedures, with examples, for how the AIP allocates its expenses to this crop insurance business and to a business under a PRP. The PRP submission should then be subject to an expert review by a qualified expert.
16. Develop cost accounting guidelines using the approaches described in the IASA Property-Casualty Insurance Accounting textbook, and allow each AIP to adapt its current internal reporting systems to satisfy the guidelines.
17. Require an actuarial certification that the premium reductions available from one or more PRPs from an AIP, or from affiliated AIPs, are not unfairly discriminatory to producers not offered a premium reduction from the AIP or its affiliates, including the detailed basis for that determination; that only differences in direct delivery and service expenses, and not differences in losses or profit sharing with third parties, were considered; and that differences between PRPs from the AIP, or affiliated AIPs, are not unfairly discriminatory to producers. The PRP submission should then be subject to an expert review by an independent qualified actuary.
18. Require an offsetting evaluation of increase expenses from profit sharing or loss contingency payments, where any expense varies inversely with losses.
19. Require an offsetting evaluation of the increase in losses or other expenses, where any type of expense reduction from business under a PRP could create an incentive for an increase in losses or other expenses from other business of an AIP or its affiliates.
20. Where (18) or (19) applies, require an actuarial certification that all offsetting increases in expenses or losses of an AIP, and its affiliates, have been considered in evaluating the expense savings from the PRP.
21. Require disclosure to RMA of all arrangements for the AIP and its affiliates where crop insurance delivery costs can be influenced by other compensation arrangements.
22. Disapprove a PRP that depends on a reduction in agent compensation unless there is clear evidence and justification as to how the agents' costs are going to be reduced.
23. Develop a fair cost measurement standard based on a confidential review of the current operations and expense recording approaches used by AIPs, and require the

AIP to submit details on how the AIP will comply with the cost measurement standard.

24. Require payment by the AIP of the costs to comply with standards, guidelines, or independent review procedures, as required by the RMA to verify the accuracy of the AIP's expense information.

We recommend that the FCIC consider those recommendations which most appropriately address the main concerns of the Board.

Biographies

The following Deloitte professionals took substantial part in this expert review. Their biographies are included in the following pages.

Robert S. Miccolis, FCAS, MAAA

PRESENT POSITION: Director, Deloitte Consulting LLP, Philadelphia, PA
Actuarial & Insurance Solutions

EXPERIENCE: Mr. Miccolis has over 30 years of experience and specializes in consulting in the areas of insurance, reinsurance, risk management, mergers & acquisitions, and actuarial services. He has expertise in all major lines of property & casualty insurance and reinsurance, as well as financial guaranty, mortgage insurance, crop insurance, weather derivatives, asbestos and environmental, professional liability, credit insurance, alternative market mechanisms (captives, risk retention groups, etc.), loss portfolio transfers, and finite risk reinsurance.

His experience also includes:
- Pricing, reserving and valuation analyses for insurance and reinsurance companies
- Actuarial pricing model design, rate plan design and pricing process evaluations
- Feasibility studies for insurance and reinsurance companies and captives
- Strategic planning, operational reviews, and underwriting process evaluations
- Financial pro forma analyses, capital adequacy testing and value-at-risk assessments
- Reviews of insurance, reinsurance and self-insurance programs
- Product and program design for insurance and reinsurance

His experience with the Federal Government includes:
- Serving as the external actuary for the U.S. Department of Housing and Urban Development (HUD) Mutual Mortgage Insurance (MMI) Program for Federal Housing Administration (FHA) loans
- Study of alternative designs for distributive shares methodologies for HUD's MMI program based on actuarial theories and principles
- Design and testing of alternative claim and prepayment actuarial models for HUD's MMI program using very large data sets

His experience in the Crop Insurance field includes experience regarding:

- Reinsurance of crop insurance programs supplementing the FCIC's SRA
- Actuarial research studying historical crop county yield distributions for producer units
- Actuarial research studying historical NASS crop county yield trends
- Application of yield distributions to determine loss rates for different levels of crop coverage based on actuarial theory from authored award winning paper
- Design and rating of supplemental crop insurance programs for an input manufacturer
- Collaborator on USDA research studying geographic correlations of crop yields
- Actuarial advisor and subject matter advisor to FCIC's external auditors

PROFESSIONAL DESIGNATIONS: Fellow, Casualty Actuarial Society
Member, American Academy of Actuaries

EDUCATION: Bachelor of Science, Mathematics
Drexel University

Geoff Lambright, CPA

PRESENT POSITION: Senior Manager, Deloitte & Touche LLP, Kansas City, MO

EXPERIENCE: Mr. Lambright joined Deloitte & Touche LLP in 1997 and is a Senior Manager in the Kansas City office. He has 8 years of financial audit experience, primarily serving the financial services industry.

Clients served include property & casualty insurance companies, health insurance companies, banks, mortgage banks, savings & loans, and governmental entities

His experience also includes:

- Assisting clients resolve complex accounting issues
- Performing internal control readiness reviews to determine a Client's future requirements to comply with the Sarbanes Oxley Act of 2002
- Performing compliance audit procedures in accordance with rules and regulations issued by the U.S. Department of Housing and Urban Development and U.S. Department of Education

PROFESSIONAL DESIGNATIONS: Certified Public Accountant
Member, American Institute of Certified Public Accountants

EDUCATION: Bachelor of Science
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Richard G. Cadugan

PRESENT POSITION: Senior Manager, Deloitte Consulting, Parsippany, NJ
Actuarial & Insurance Solutions

EXPERIENCE: Mr. Cadugan joined the firm in 1994 and has over twenty years of diversified experience in consulting and the insurance industry, including eight years in property/casualty underwriting and operational roles at two major multi national insurance companies. His principle areas of expertise include strategic planning, benchmarking, operations and process design, underwriting, risk management, and financial management and reporting. He has consulted in many areas of the industry including property/casualty, life & health, and retail and reinsurance brokerage.

His experience also includes:

- Development of the firm's proprietary tools for Insurance Industry process and procedure modeling
- Firm resource on many reinsurance related process and procedure engagements
- Has worked on numerous regulatory projects both in the U.S. and abroad
- Recipient of the International Insurance Society 1999 Chin Research Award

CLIENTS SERVED:

- Munich Re Group
- American Re
- AIG
- Kemper
- CNA Insurance Companies
- Prudential
- Chubb Group
- Lloyd's of London
- Arabia Insurance Company (Lebanon)
- La Buenos Aires Seguros (Argentina)
- Life of Jamaica, Ltd
- Banco de Seguros (Government of Uruguay)
- BMW Financial Services, N.A. (Germany)
- Overseas Partners Re (Bermuda)
- Ministry of Finance (Thailand)

PROFESSIONAL AFFILIATIONS: Member, American Risk and Insurance Association
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EDUCATION: Post-graduate study, Risk Management and Insurance, Florida State University
M.B.A., Rensselaer Polytechnic Institute
B.A., The Virginia Military Institute