Expert Review of the CI-Premium Reduction Plan Issues-04-02

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Executive Summary

On its surface, the introduction of a premium reduction plan, or PRP, would appear to be a positive step for the crop insurance program. Presumably, farmers would benefit from reduced premium and approved insurance providers (AIPs) would introduce cost efficiency measures in order to compete for business. Based on this review, however, several concerns emerge which put in question the introduction and implementation of any type of PRP program.

At the outset, it is not clear that PRPs will generate a substantial increase in participation. The national participation rate is approximately 80% (as measured by eligible acres enrolled in the program). The agricultural economics literature indicates that participation response to further premium reduction is reasonably inelastic. There is also no evidence to suggest that ad hoc supplemental disaster assistance will be reduced or eliminated in the crop insurance program even if the PRP is effective in increasing participation.

PRP schemes will undoubtedly come in a variety of forms and have a myriad of unintended and unanticipated impacts. These consequences cannot be predicted. Because PRPs are “financed” through administrative and operating (A&O) reimbursement savings, it may well be the case that reductions in farmer paid premium will come at the expense of service to the farmer. Based on an earlier study conducted by the Economic Research Service (ERS), it is also not clear that incremental premium reductions will have much, if any, benefit for socially disadvantaged, limited resource farmers.

The process of administering the “program dimension” of PRP implementation appears quite problematic. Issues such as program phase-in, selection of targeted states, phase-in by crop or plan all suggest increased reporting requirements for providers and increased monitoring and oversight by FCIC and RMA. These activities may provide a vehicle for meeting perceived expectations of constituency groups, but they are likely to introduce serious program integrity and administrative issues.

Fundamentally, the current PRP review process establishes maximum rates with prior approval for downside deviations. This strict regulatory approach has several disadvantages that are discussed in our review. Strictly regulated markets may deter new entrants while participating companies may exit the market. It may also be the case that current RMA rates are not adequate in all areas, resulting in distortions across states and regions.

Monitoring of PRPs is expected to be a difficult process. Additional expense reporting and cost accounting standards will have to be developed, implemented and monitored. Historically, state insurance departments have not been entirely successful in this arena. It is not clear that RMA has the resources necessary to direct a national-level rate approval process. RMA should consider alternative approaches to transferring anticipated efficiency benefits to farmers.

With respect to recommendations, RMA should undertake a comprehensive study of the concerns identified in this review as part of a broad rule-making process and should discontinue

acceptance of any application for a PRP program until such time as a final rule is published. One solution to the problems currently faced by the government due to the introduction of premium reduction plans is to eliminate these plans and return to a mandated rate system. An alternative solution is to move toward an open competition system. On this basis, insurers would develop final rates based on the RMA loss costs, with competition used to regulate the general level of rate adequacy. Government regulation would be limited to ensuring the financial stability of the program. Either of these two approaches, mandated rates or open competition, would require legislation to implement. A third solution is to allow companies to share their profits with producers through the use of policyholder dividends. This would eliminate any need for the government to manage the rate approval process and eliminate the issues regarding expense allocation and reporting. RMA would have the final authority to determine whether the company would be allowed to pay the dividends.

Review Methodology

1. Each review team member was assigned to individually review the materials.

2. In review team meetings, the group reviewed and prepared responses to each question listed in the Statement of Work.

3. An executive summary was prepared on the basis of responses to 1. and 2. above.

Required Analysis

As directed in the Task Order Statement of Work, we are providing our review with respect to Section 508(e) of the Act.

(a) The expert reviewers' written reports will address each of the following items within the scope of the expert reviewer's knowledge:

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.

    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.

    Past experience has shown that participants will purchase higher coverage levels as subsidies increase (Davidson, 2002 testimony). One would expect a similar response due to the availability of PRP reductions. Currently, the national participation rate (as measured by eligible acres insured) is roughly 80%, and the program appears to be operating in the inelastic portion of the demand schedule. Thus, any further improvements in participation due to reductions in farmer paid premium are unlikely.

    Analysis of RMA Summary of Business data for 1997-2004 shows that there is noticeable variation in average rate from one year to the next, for any particular cohort of producers (State, County, Crop, Practice, Type, Coverage Level, Insurance Plan). There is approximately 19% incidence rate of 10% decrease, and 25% incidence rate of 10% increase. In view of this, a 10% rate discount occurs frequent enough to pass unnoticed, and is not likely to trigger a response by producers with respect to their purchase of crop insurance. In the following table, "R" is the ratio of one year's average rate divided by the previous year's average rate, provided both are measurable for a particular cohort.

Ratio "R"	Count	Incidence Rate
0.0-0.9	70,856	19.5%
0.9-1.1	200,742	55.3%
> 1.1	91,207	25.1%
Total:	362,805	

As an alternative to the analysis of Summary of Business data, estimates of acreage response using demand elasticities found in Glauber & Collins (2002) indicate that further reductions in farmer paid premium result in only minimal increases in acres insured with either no change in total premium or declines in total premium based on demand elasticity assumptions.

Applying a $0.40 per acre reduction in farmer paid premium to 2004 insured acres and the 2004 average farmer-paid buy up rate per acre results in acreage increases of approximately 3% and 1% for demand elasticities of –0.6 and –0.3, respectively. Under these scenarios, estimates of total premium remain virtually unchanged or decline, which ultimately results in a decline in estimated A&O reimbursements. Thus, in aggregate, the crop insurance industry has no incentive to pursue the development of PRPs.

b. The Board also wants to know if such changes will likely contribute to decrease the need for future ad-hoc agricultural disaster assistance.

According to Glauber & Collins (2002), Congress has not restricted ad-hoc disaster assistance due to the availability of higher subsidy levels for crop insurance, which has reduced farmer-paid premium. There is simply no evidence to suggest that increased crop insurance participation prevents or reduces ad hoc disaster assistance (Glauber & Collins 2002, pp. 90-91, p. 98.)

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.

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 following chart summarizes likely PRP impacts on agent workforce, agent training, claims adjustment, AIPs, the marketplace and service to producers.

Anticipated Impacts Associated with Alternative Premium Reduction Plans

		Alternative Premium Reduction Plans (PRPs)				
		PRP Reductions Between/ Within States	**Timing of Events (Early payment of premium)**	**Reduced Agent Commission**	**Reduced LAE**	**Reduced Profits from A&O**
Impacted Process or Constituent	**Agent Work Force**	Consolidation in agent force; possible third party service providers; new agent responsibilities	Spread or reduce peak agent workload	Decrease agent incentives and work force; movement of agent books between AIPs	N/A	N/A
	Agent Training	Increased training and responsibilities in states with programs	Increased training (increase service costs will offset some efficiency gains)	Decreased incentives for being trained	N/A	Increased service costs will offset some efficiency gains
	Claims Adjustment	Decreased resources for claims activity in targeted states	N/A	N/A	Decreased resources for claims activity	Inability to address emergency claims situations
	AIPs	Less profit in good states with no offset in marginal states; could reduce new entrants	Lock in the business early; could result in higher renewal rates	Shift more work back to the companies—increased competition between companies and agents	Shift more work back to the companies—increased competition between companies and loss adjusters	(a) Less profit reducing incentives for entry, and (b) limiting ability to accumulate reserves for sustaining higher than normal loss ratios
	Marketplace	Potential introduction of third party service providers (or proliferation of AIPs) could alter current market structure	Potentially streamline marketplace operations	Potential introduction of third party service providers, possible innovation in sales technology	Potential introduction of third party service providers, possible innovation in loss adjustment technology	Less resources for product innovation
	Service to Producers	Reduced service	Benefits qualified producers (better managed operations)	Reduced service	Reduced service	Reduced service

In order to avoid unfair discrimination and allow for maximum farmer participation, it may be useful to consider PRPs only for those AIPs with books of business that model or mimic the national book. Also, the PRP must encompass the entire book of the AIP. The reduction must be fairly uniform and offered in all states for all plans of insurance. This form of global requirement naturally eliminates single-state or smaller AIPs, but such a requirement would attempt to preclude “predatory pricing” in desirable states or regions between large and small AIPs.

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.

Benefit/Risk	**All States and Plans**	**Limited Number of States**	**Limited Numbers of Plans of Insurance**
Benefit	Benefits all producers, simplifies accounting cost issues, avoids unfair discrimination, less effort for RMA to regulate	Reduces extent of negative outcome, allows for company specialization	Focuses efficiency gains on simplest plans
Risk	Does not recognize possible cost differentials between plans	Introduces potential discrimination across states, introduces adverse selection among states	May encourage coverage selection based on premium rate rather than risk protection

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.

Limiting the number of states is somewhat akin to a phase-in. Please see our response to question 4.a.

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.

Limited resource farmers can currently obtain CAT coverage for free with no administrative fee. However, they tend not to participate in the program. PRP reduction would have no appreciable effect in increasing participation with these growers.

According to the 1997 USDA ERS study, (page 21), (see references), limited resource farmers have little interest in purchasing buy-up coverage even with additional subsidies – unless the premium is free.

To further assess these kinds of impacts, a follow-up survey should be conducted (by a third party) to directly extract this information during the period the discount is in effect. The target population is the set of small, minority and limited resource farmers, not the entire population of producers. The producers can be randomly selected from this reduced set, and sent questionnaires.

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.

      Phasing-in a PRP has identifiable benefits and risks. While it always is tempting to assume that a "phase-in" is a modest and prudent way to introduce change, this only is true if the available resources (both at the regulatory level and the company) are sufficient in number and in sophistication to ascertain whether the phase-in is having an adverse, or potentially adverse, effect or series of effects. Identifiable potential adverse effects include, but may not be limited to, undermining program integrity (by short circuiting, for example, the underwriting and loss adjustment processes), weakening a company's financial strength, and focusing company resources on the most profitable states to the detriment of farmers in less profitable states. Thus, before committing to a phase-in approach, RMA should satisfy itself that it has ample resources to identify such potentially adverse consequences and, potentially to assure itself that an AIP's phase-in is not being managed in a way that distorts either program objectives or its own financial strength.

      The following paragraphs identify the benefits and risks of a phase-in approach. If RMA permits or requires a phase-in, each AIP should be responsible for implementing the discount in yearly stages, with the intent to eliminate or reduce the discount if the purported efficiency does not manifest itself to the satisfaction of RMA and the AIP.

Benefits: Phase-ins allow for comparative advantage and the ability to maximize efficiency gains depending upon nature of specialization while mitigating the public perception downside from a PRP plan that cannot meet RMA requirements. Limited introduction could encourage established AIPs to innovate in certain regions. With respect to the magnitude of the discount, a phase-in allows for a premium reduction while allowing AIPs with A&O profits to retain some portion of these profits.

Risks: Phase-ins could encourage adverse selection in the most profitable states while not correcting problems in unprofitable states. One outcome might be selection among plans with the greatest cost efficiencies regardless of risk protection benefits of the plan for the farmer. Phase-in by crop could possibly impede the introduction of new crop plans, and possibly distort land allocation decisions. Phasing-in the discount leaves open the issue of the "true efficiency" gap. That is, if A&O profits exist, then how much is being withheld from the farmer.

Any phase-in process will require additional resources to be allocated to monitoring and oversight resulting in overall cost increases for the program, for both industry and RMA.

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 most straightforward approach to the question is to simply allow AIPs to annually apply for a PRP in the states in which the PRP meets all other FCIC/RMA requirements. Establishing formal criteria to determine the initial number of states along with establishment of the timeline for full implementation will become unwieldy. The use of an annual applications process to be completed and authorized by FCIC in a timely fashion eliminates the need to establish the additional procedures envisioned in question 4.b.

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.

	Established AIP		New AIP	
	Benefit	**Risk**	**Benefit**	**Risk**
No Change During Phase-In	Forces discipline with introduction of PRP	Might discourage introduction of PRP if requirements viewed as inflexible	Forces discipline with introduction of PRP	Discourages new entrants; possibly subject to market power of dominant players
Changes During Phase-In	Allows for “learning” by doing; encourages innovation if flexible	Allows capricious behavior and could introduce market uncertainty	Allows for learning; encourages innovation	Subject to market power of dominant players

In developing our response to question 4, we have attempted to categorize the issues surrounding the notion of a “phase-in” program and anticipate what we believe to be the salient concerns. In summarizing our response, it seems that a “phase-in” program introduces a myriad of questions and concerns regarding the problematic nature of the “phase-in” and how such a process could be effectively monitored. As such, FCIC may wish to consider an alternative regulatory structure similar to the annual prior approval process conducted by state insurance departments. We discuss this notion in greater depth in our responses to questions 5-8.

<u>Questions 5 through 8:</u>

Questions 5, 6, 7, and 8 all relate, directly or indirectly, to the issue of expense accounting and its use in supporting requests for premium reduction plans. The broader issue that needs to be considered is the general approach to rate regulation for the Federal crop insurance program. Prior to the introduction of premium reduction plans, the program was regulated using a mandated rate approach. In the absence of rate competition, companies competed for business through the use of agent commissions and, as permitted, through the offering of innovative coverages. In recent years, companies have been permitted to offer premium reduction plans. These plans have been regulated on a prior approval basis, with companies being required to provide supporting information each year the plan is in effect. A third approach to rate regulation is through open competition. Open competition is the most common approach used for state regulation of Property/Casualty industry rates. Three different methods for implementing an open competition system are file and use, use and file, and no-file. Under a no-file approach, company rates are unregulated. However, rates are still required to conform to statute and the regulator generally retains the right to review the company’s documentation in support of its ratemaking decisions. Under the file and use approach, rates must be filed with the regulator prior to becoming effective. Under the use and file approach, rates must be filed within a reasonable time after they become effective. For either of the latter two approaches, the regulator retains the right to reject a company's rate filing. In practice, this is rarely done because competition is expected to provide adequate control over a company's rating decisions.

Rate regulation involves a balance between several competing public policy objectives. (See *Principles of Risk Management and Insurance*, Volume 1. Williams, C. Arthur, Jr., Head, George L, Glendenning, G. William. American Institute for Property and Liability Underwriters, Malvern, Pennsylvania 19355. First Edition, 1978.) Perhaps the most important objective is to preserve and enhance the financial stability of insurers. Since insurance involves a promise to pay future benefits, the insurer's ability to meet these obligations is considered a legitimate public interest that justifies rate regulation. From this perspective, the regulator's primary concern is that the insurer's price should be adequate to cover its potential obligations and to ensure the continued viability of the insurance market in the future. Another important objective is to ensure fairness, equity, and reasonableness in the insurance market. A competitive market is considered to be the most effective method for ensuring that these goals are met. Regulation becomes relevant in those situations where competition is not effective in regulating rates in the insurance market.

These objectives are echoed in the CAS Ratemaking Statement of Principles, which states that rates should be adequate, not excessive, and not unfairly discriminatory. Adequate rates help to ensure that the insurer is able to meet its obligations and that insurance coverage will be available in future periods. Rates are presumed to be not excessive provided that there is a reasonable degree of competition in the insurance market. Rates are not considered unfairly discriminatory if they are directly related to the expected costs. More specifically, the Ratemaking Statement of Principles states that "a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer." This definition of unfair discrimination is less restrictive than the definition proposed by RMA.

As stated above, the Federal crop insurance program currently permits the use of premium reduction plans. This allows reductions, but not increases, from the standard premiums. In this sense, RMA regulates the program by establishing maximum rates, with prior approval required for all downward deviations. Implicitly, the public policy objective underlying this regulatory approach is to prevent insurers' rates from being excessive. This approach presumes that a reasonable degree of competition in the insurance market does not exist. However, if this becomes the primary focus of regulation, it creates the risk that other public policy objectives are not being met. In addition to preventing rates from being excessive, the regulator needs to be concerned about the financial performance of the insurer and the on-going viability of the insurance market. In a government-supported program, the regulator also needs to be concerned that coverage is readily available to all potential program participants. These objectives are not readily compatible with a maximum rate regulatory system.

The current regulatory approach for the Federal crop insurance program, based on maximum rates with prior approval required for downward deviations, shares a number of disadvantages in common with other forms of strict rate regulation. The most significant disadvantage is that private insurers tend to avoid markets that have strict regulatory requirements. The introduction of rate restrictions generally leads many of the participating companies to exit from the market. Afterwards, relatively few, if any, new participants are likely to enter the market. In this sense, strict rate regulation has a significant adverse effect on the marketplace and reduces competition by driving insurers from the market.

A second disadvantage of the current regulatory approach is that the rate may not accurately correspond to the true cost. In a competitive market, rates tend to move quickly toward an adequate level. In a highly regulated market, the market pressures that drive rates toward an adequate level do not exist. If rates are too low, company financial strength can be compromised. Companies that offer other coverages may be able to offset the rate inadequacy on the Federal program by charging a higher rate on other coverages. However, cost shifting is not a desirable outcome of rate regulation. Inadequate rates may also limit the availability of coverage, with fewer companies willing to provide insurance in the underrated areas. On the other hand, if rates are too high, farmers may choose to purchase less coverage or none at all. This could result in increased reliance on Federal disaster relief. In practice, this may not be a significant concern due to the large subsidies available to producers. With the introduction of premium reduction plans into the existing Federal crop insurance program, farmers in the more profitable market segments may be offered discounts due to competitive pressures. This would reduce the profitability of the program, though this may be counterbalanced to some extent by an increase in participation (provided that participation is not already high in these market segments). Discounts are unlikely to be offered to producers in the less profitable states. On a countrywide basis, for all companies combined, the profitability of the program would be reduced. This would have an adverse impact on the overall profitability and the financial strength of the industry.

A third disadvantage arises from the manner in which the Federal crop insurance program is regulated. An insurer may be able to take advantage of the program by providing coverage only in the most profitable market segments. This problem would be magnified if a new competitor were permitted to offer a PRP discount since this would accelerate the transfer of business from the established companies. From a regulatory perspective, this has two adverse impacts on the public policy objectives of the program. First, it would undermine the insurance market as a whole since the new companies would not take their fair share of the undesirable business. The established insurers would retain all of the less profitable or unprofitable business, which might conceivably lead to these companies becoming insolvent or withdrawing from the market. Second, this would have an adverse impact on the availability of coverage to program participants in the less profitable market segments, particularly after the withdrawal of the established insurers from the program. Open competition avoids this type of problem by allowing all rates to move toward an adequate level.

The impact of premium reduction plans on agent actions also needs to be considered. If companies justify their discounts by reducing agent commissions, agents may respond by shifting business to other companies. Also, if commissions decline overall, the number of agents who sell coverage may be adversely impacted. Whether this would have a significant impact on the program is unknown.

Another issue that arises as a result of strict rate regulation is that companies are required to provide justification for their ratemaking decisions. This issue is the basis for questions 5, 6, 7, and 8 of the Task Order. Accounting practices in themselves introduce a number of thorny issues. At some point in the past, state insurance regulators had attempted, unsuccessfully, to develop a set of uniform standards for insurance accounting. This attempt failed because of significant differences in how insurers operate. All that the regulators were able to achieve was to require that all insurers report their results using a consistent set of expense categories, as specified in the Insurance Expense Exhibit of the Statutory Annual Statement. Within that framework, insurers are free to account for their expenses as they see fit. Based on their different methods of operation, it should not be expected that RMA would be able to develop a set of uniform accounting standards for regulating the companies participating in the Federal crop insurance program. State regulatory issues, as just noted, illustrate the ultimate futility of any such effort.

Under a prior approval system for premium reduction plans, one issue that will need to be addressed is the basis on which the expenses should be developed. Question 5a of the Task Order raises a specific issue regarding the use of reinsurance year as compared to calendar year results. A similar question could be asked regarding the use of direct vs. net expenses. If net expenses were used, reinsurance commissions would be treated as an offset to direct commissions. This would make it easier to justify a PRP discount. In addition, the treatment of reinsurance premiums as an expense item would need to be resolved. Historically, the actuarial profession has been inconsistent in whether reinsurance should be treated as an expense item in evaluating rate decisions on a direct basis. Another question arises with regard to GAAP vs. Statutory accounting for expenses since the two accounting standards differ in their treatment of accruals for prepaid expenses. Whether the cost of capital should be considered an expense, as required by the Actuarial Standards of Practice, would also need to be considered. Unfortunately, the proper method for evaluating an insurer's cost of capital is still an open issue in the actuarial profession.

The experience used for justifying the company's discount would also need to be carefully considered. Expenses that vary over time can present a distorted picture of the true cost. For instance, the inclusion of only low loss years could be used to justify a discount based on the low level of loss adjustment activity. Similarly, a company with an unprofitable book of business could respond by paying a reduced commission in a given state. This might make it possible for the company to justify a discount based on the lower expenses for that state, even though its book of business is unprofitable. Another concern is the distinction between historical and prospective expenses. While a company may claim that its future costs will be less, it may not be possible to determine whether the anticipated savings have actually been achieved.

Another issue is that expense data is easy to manipulate. Certain costs, such as commissions, can be identified as being associated with a specific policy. For most of the remaining costs, allocation methods are used. Changes in allocation methods increase the potential for manipulation to achieve a desired result. Each insurer may use a different allocation method, and an individual insurer's methods may change over time. Even if an insurer's expense data is reliable in aggregate, it need not be accurate at the level of detail at which costs are allocated. In addition, expenses are generally not allocated below the level of detail required by the Annual Statement. If a company were to file a premium reduction plan for a smaller segment of its book of business, additional expense allocations would be required. There is no reason to expect that these expense allocations would conform to any consistent standards. In general, expense allocation can lead to cost shifting between states, coverages, crops, plans of insurance, and market segments. Similar issues arise in the regulation of other Property/Casualty coverages. Insurers are often very creative in preparing support for their rate filings despite the attempts of state regulators to require reasonable justification for the filings. There is no reason to anticipate that RMA will be more successful in its attempt to ensure that rate decisions will be rationally supported.

Other issues relating to the use of expense data are that costs can be shifted between entities, such as between an MGA and an insurer. An unregulated third party service provider could conceivably be used to disguise program delivery costs. Insurers that operate through more than one company entity may be able to show lower expenses in one company versus another simply through cost allocation procedures. One insurer may record any management fees paid to controlling companies as an expense while another might record it as a stockholder dividend. Fronting fees can be treated as an expense or might be shown as a sharing of the company's profits. Certain expenses can be reported as capital investments (i.e., capitalizing the cost of certain activities over time). Other expenses may be reported as losses (e.g., salvage and subrogation expense). Expenses paid to third parties might be recorded as loans or a sharing of company's profits. This is particularly the case with agent commissions, since contingent commission agreements are often designed as a profit sharing arrangement between the company and the agent. Similarly, policyholder dividends can be considered to be an expense or as a distribution of the company's profits. The timing of expenses can distort the actual cost, such as by delaying payments to third parties.

In summary, the government should not expect that it will be able to design and enforce a strict regulatory system that ensures that companies offer discounts that fairly represent their actual cost efficiencies. In the past, NCIS has worked with Pricewaterhouse Coopers, Deloitte, and a joint crop insurance industry taskforce in an attempt to address the issue of industry expense information. If the FCIC Board is interested in the design of accounting standards, it may want to contract with one of the major accounting/consulting firms with experience in the Property/Casualty insurance business. In so doing, the Board should establish formal policy guidelines regarding the role of insurance providers, the regulatory role of RMA, and the policy goals of the program.

From a strictly economic perspective, the most effective system for rate management is open competition. This would allow insurers to establish both upward or downward deviations from the RMA rate level. Over time, the marketplace will reward those companies that can successfully manage their own operations. Under this system, regulation would be limited to ensuring the stability of the insurance system. Other types of regulatory oversight may be necessary, but will add to the cost of the program for both RMA and the insurance industry. The problems arising out of a prior approval system for PRP discounts will only intensify over time. Companies will always be able to find ways to justify discounts if those are needed for competitive reasons, such as through the use of additional corporate entities. Verifying whether the claimed efficiencies have actually been achieved may not be possible. The questions posed in the Task Order are framed from the point of view that the government will attempt to manage and monitor rate competition at a high degree of detail. Not only is this impractical, it is likely to be costly and ineffective. To avoid these problems, the government should either mandate all rates or permit open competition so that the market can establish rates based on the RMA loss costs.

As an alternative to rate regulation, the government could allow companies to share their profits with producers through the use of policyholder dividends. This would eliminate any need for the government to manage the rate approval process. Instead, companies would file their dividend plans with RMA at the start of the year. The decision to pay policyholder dividends would be at the discretion of each company's Board of Directors, perhaps with final approval by RMA. Expense allocation would no longer be an issue since companies would base the dividends on their total experience. This approach would have the added advantage of encouraging farmer behavior that benefits the program since farmers would be given an incentive to better manage their operations in order to maximize their dividends.

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.

       In addition to the observations made with respect to questions 5-8, it is worth noting here that the Federal crop insurance program has several features which increase the difficult in addressing the accounting issues. The observations made in 5a illustrate one of these – that the reinsurance year concept, which is important to the program, may be meaningless for traditional financial reporting purposes, including accounting for and allocation of expenses. Another is that implementation of an innovative efficiency in selling crop insurance (such as receipt and processing of electronic applications or renewals) may entail a corresponding, but deferred and perhaps not easily quantifiable expense in another area such as claims handling or loss adjustment. All of these observations require us to respond to 5a by stating that AIPs' premium reduction plans likely will require fairly precise line of business accounting of all expenses, including overhead, that need not be done on an enterprise basis. This perhaps leads to accounting certification requirements imposed on company auditors or executives, and it undoubtedly should involve heightened scrutiny and deployment of additional RMA resources for monitoring purposes.

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.

Please see our response to question 5a. In addition, we comment that this cannot be accomplished without requiring AIPs to submit detailed business plans, most likely accompanied and supported by analysis provided by external consultants (such as accountants or actuaries) and without having appropriately credentialed experts on RMA's side, whether internal or specifically retained for this purpose, to review these plans and the supporting analytical work.

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.

Please see our overall comments with respect to question 5-8 and our responses to 5a and 5b.

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.

We feel the costs are inseparable. This inseparability is a good reason to require that premium reduction plans be offered in all states rather than using a "phase in" approach. Please see our overall comments with respect to question 5-8 and our responses to 5a and 5b.

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.

Please see our responses to 5a, 5b, and 5c.

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.

This subject was addressed to some extent in the overall comments to questions 5-8. If RMA wishes to pursue this further, this should be the subject of another consulting contract. This is primarily an accounting issue, which is not our area of expertise.

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.

Please see our response to 5f.

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.

Please see our responses to 5a, 5b, 5c, and 5f.

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.

This summary of PRP applications already demonstrates the risks that PRP can be used to “game the system” and to make less transparent the program and market integrity issues raised by this option. Creation or use of multiple entities can act as a device to delay or defeat appropriate monitoring of the success of premium reduction plans.

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

Using affiliated entities to offer PRP on a selective basis would entail serious risks. As noted, this could become a device for concealing the financial impacts of a PRP offering. This could also become a device for protecting core business in more profitable states. For instance, an AIP could form multiple entities, and then liquidate the ones that are unprofitable without any risk to brother/sister affiliates operating in other states. While the AIP would lose its investment in the liquidated entity, it would have protected its profitable core business. Such a legal structure, when created and implemented solely to gain or retain market share, could weaken the overall program and shift more indemnity costs to the government through the "cut through" provisions in the SRA.

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

Overall program integrity would be compromised. Please see our response to 6a.

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.

The entities in the prime states would succeed, and entities in less profitable states would fail. Please see our response to 6a.

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

The best way to avoid the problem is to negate the possibility of its occurring. This can be done by prohibiting selective discounting (in other words, requiring the PRP discount to be available in all states in which an AIP does business) and by limiting approval of PRP applications only to those companies with a book of business similar to the program as a whole.

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.

   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.

      In accordance with statutory accounting principles, profit sharing arrangements with agents should be recorded as contingent commissions and treated as any other expense entry. In general terms, we might expect that virtually all payments other than losses, stockholder dividends, and policyholder dividends should be included as part of the AIP's operating expenses. This does not necessarily mean that these items should be included in the evaluation of the insurer's cost structure. For instance, if the AIP has an agreement with another entity that permits it to reduce the compensation being paid, then this would seem to be a real savings. However, without a careful review of the various types of profit sharing arrangements, it may not be possible to conclude whether this will always be the case. For instance, a reinsurance transaction could be considered to be a profit sharing arrangement. Whether the cost of reinsurance should be included in the company's expense figures for purposes of determining its PRP discount may not be clear and may depend on the financial and operational relationship between the companies.

   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.

      Please see our response to 7a.

   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.

      A decrease in agent compensation could result in the agent fleeing to a competitive provider that offers an equivalent discount without a decrease in agent compensation.

The producers, seeing the same discount either way, would probably continue to obtain coverage through the same agent. In evaluating the PRP discount, the insurance provider is responsible for estimating the amount of efficiency being lost as a result of agents shifting the business to other companies in response to the reduction of agent compensation. Small and limited resource farmers are not likely to figure into the "stability" picture, as explained earlier.

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.

    Please see our response to 5a.

    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.

    The role of an auditor is to determine whether a company's financial results are fairly stated and in compliance with statute, regulation, and accounting standards. The auditor's role does not encompass the company's interpretation of its results or the use of this information in estimating its future costs. Future costs are estimates based on assumptions that may or may not be reasonable, and that may or may not be borne out by future events. In addition, premium reduction plans may be designed to apply only to a segment of the company's business. Since this may require that a company's aggregate expenses be allocated to smaller segments of its business, there is no way to know whether these expense allocation methods provide reliable estimates of the true costs for every segment of its business. The involvement of an independent certified accountant in support of a premium reduction plan would not eliminate the intrinsic indeterminacy of the true costs.

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.

   Open competition in the marketplace is the most effective approach to dealing with these issues. Please see our overall comments with respect to question 5-8.

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

   Please see our response to 8b.

(b) The expert reviewer's written report may include additional information at the discretion of the expert reviewer.

Accounting Transactions

The accounting transactions associated with the PRP concept are not clear from the review materials, at least to this review team. It is our understanding that the efficiency demonstrated by the AIP is passed to the farmer, and the farmer paid premium is reduced accordingly. What is not clear is the "gap" in total premium. Does the AIP make up the difference to RMA in order that total premium is maintained in the system? Or, is the reduced premium passed through the system for purposes of loss ratio and SRA gain/loss calculations. If so, does the AIP (can the AIP) claim the difference as an expense for the subsequent year?

It is not clear to us how the system remains "whole." Are these types of accounting transactions a component of each individual PRP submission? If so, oversight of multiple PRP submissions could be very complex, and development of fair standards and procedures would seem to be problematic at best.

Impact of Commodity Prices

According to the "Procedures for Premium – Reduction Application," efficiency is defined as the difference between the A&O subsidy and actual A&O costs and the cost for new entry and anticipated growth for new and existing AIPs, respectively. As such, the amount of efficiency will depend, in part, on the relationship between agricultural commodity prices and actual A&O expenses. In the presence of high commodity prices, "measured efficiencies" will be greater than in a low commodity price regime regardless of the ability of an AIP to reduce its costs or operate on a more efficient scale. Thus, introduction of PRPs may at times be more a function of commodity price regime rather than cost efficiencies or introduction of cost-reducing technologies. In some sense, this should not matter as long as the farmer benefits through reduced premium.

Program Distortions

General reaction is that PRP-based schemes will result in adverse selection toward the most profitable states and crop plans. As such, it seems that the "re-balancing" issue, which surfaced during the recent SRA re-negotiation, will only become exacerbated. Without some form of counter-balancing in less profitable states, the introduction of PRP-based schemes could be detrimental to the long-term health of the program.

Recommendations

One alternative for RMA to consider is to discontinue the current PRP program until such time that a formal rule-making process can be completed. The rule-making process would establish guidelines under which a PRP application can be made and would be approved or disapproved. The current PRP program is unjustifiably limited to a single AIP, yet, as outlined in our review, expansion of this program to any number of AIPs is fraught with unworkable administrative oversight requirements, increased program costs, and questionable program benefits. At a minimum, RMA should further study the concerns raised in this review as part of a broad rule-making process and should discontinue acceptance of any application for a PRP program until such time as a final rule is published.

Due to the introduction of premium reduction plans, the old system of mandated rates for the Federal crop insurance program has broken down. RMA has quickly discovered that the ability of companies to offer a competitive discounts immediately leads to increasing efforts to enable companies to implement widespread rate reductions. Despite the government's efforts to regulate this process, companies will always be able to find creative ways, such as the use of additional corporate entities, to justify discounts if those are needed for competitive reasons. Verifying whether the claimed efficiencies have actually been achieved may not be possible.

The unstated assumption underlying the Task Order is that rate regulation of the Federal crop insurance program should continue on its current course. The Task Order identifies a number of issues that need to be addressed in order to make the current system more effective. If RMA intends to regulate rates through the use of premium reduction plan system, then RMA also needs to ensure that expense accounting is performed in a sufficiently rigorous manner, and that it is enforced and strictly regulated by RMA. In addition, RMA would need to put into place mechanisms to ensure that all participating states are equitably served by all AIPs. Whether RMA will be able to effectively manage and monitor rate competition with its current resources is uncertain. The responses to the eight questions provided above also raise the issue of whether this objective can actually be achieved.

One solution to the problems currently faced by the government due to the introduction of premium reduction plans is to eliminate these plans and return to a mandated rate system. A better solution is to move toward an open competition system. On this basis, insurers would develop final rates based on the RMA loss costs, with competition used to regulate the general level of rate adequacy. Market pressures would result in rates moving quickly toward adequate levels, with improved rate equity across states and crops. Companies that charged excessive rates would be penalized by a reduction in their market shares. Government regulation would be limited to ensuring the financial stability of the program. RMA could also be involved in monitoring rates to ensure that rates are adequate, not excessive, and not unfairly discriminatory. Either of these two approaches, mandated rates or open competition, would require legislation to implement.

A third solution is to allow companies to share their profits with producers through the use of policyholder dividends. This would eliminate any need for the government to manage the rate approval process and eliminate the issues regarding expense allocation and reporting. Companies would simply file their dividend plans with RMA at the start of the year for approval. RMA would have the final authority to determine whether the company would be allowed to pay the dividends. This approach would have the added advantage of encouraging farmer behavior that provides a benefit to the program since farmers would be given an incentive to better manage their operations in order to maximize their dividends.

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Biographies

Thomas P. Zacharias, Ph.D.
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Tom Zacharias joined NCIS in July of 1990. He holds a Ph.D. in Agricultural Economics from the University of Illinois, with B.S. and M.S. degrees in Agricultural-Economics from Texas A&M University. Prior to joining NCIS, Tom was an Associate Professor in the Department of Economics at Iowa State University in Ames, Iowa and an Assistant Professor in the Department of Agricultural Economics at Louisiana State University in Baton Rouge, Louisiana.

Tom has published 4 book chapters, 12 refereed journal articles, 3 book reviews in peer-reviewed journals, and over 75 other publications, including numerous professional and agricultural extension presentations. In 1993,Tom co-authored a paper published in the 1993 Casualty Actuarial Society Forum entitled, “Crop-Hail Insurance Ratemaking.” Recently, he has co-authored a paper entitled, “Ratemaking Considerations for Multiple Peril Crop Insurance,” published in the Winter, 2000 Casualty Actuarial Society Forum. Tom is a member of The American Agricultural Economics Association.

Frank Schnapp
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Frank Schnapp has been the Director of Actuarial Analysis and Research for National Crop Insurance Services since August 1998. During 2004, he was promoted to the position of Vice President of the Actuarial & Statistical Information Services division of NCIS. Mr. Schnapp is an Associate of Casualty Actuarial Society and a member of the American Academy of Actuaries, and brings twenty-five years of actuarial experience this position. In addition to 20 years of experience in pricing property and casualty coverages, Mr. Schnapp has more than six years experience with Crop-Hail and MPCI insurance actuarial analysis. Mr. Schnapp was the lead author and presenter of a paper on MPCI ratemaking, which was published in the Winter 2000 Casualty Actuarial Society Forum.
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Rich Byrne
Director Analytical Operations

Rich Byrne has worked for National Crop Insurance Services since 1988. Mr. Byrne earned an M.S. from Colorado State University majoring in Statistics (1980) and a B.A. from Pomona College majoring in Mathematics. He began his career at NCIS as a Research Statistician for seven years, advancing to Director of Information Services, and for the last seven years as the Director of Analytical Operations. Mr. Byrne has fifteen years experience in statistical analysis of crop insurance systems including extensive exposure to MPCI in particular. Mr. Byrne has extensive experience in storage, retrieval and management of crop insurance data, in particular, crop-hail industry data. Mr. Byrne’s risk management experience also includes the design and implementation of a Geographical Information System (GIS) for crop insurance data.

Troy Brady

Director Data Quality and Systems Design

Troy Brady joined NCIS in April 1994, where he serves as the Data Quality & Systems Design Director. Mr. Brady has a BS/BA with a double major in Computer Information Systems and Accounting from Central Missouri State University. Mr. Brady is responsible for data collection and data quality assurance and the development of databases and systems for the collection and storage of NCIS's crop insurance data. Mr. Brady also serves as the staff liaison to the Technology & Information Processing Committee, a standing committee to review information technology issues for the industry, including facilitating communication between the Risk Management Agency and the industry on processing and program issues. Mr. Brady previously served as the Actuarial Database Branch Chief at FCIC where, over a nine-year period, he developed FCIC's Actuarial Document System, Experience Databases, RMA's NASS database, Data Acceptance and Reinsurance Accounting Systems (DAS/RAS), and the Policy-Holder Tracking System. While at FCIC, Mr. Brady oversaw the development of three new organizational units including the Actuarial Data Base Branch and its Data Quality Section as well as FCIC's Information Branch.

Dave Hall

Director Program Evaluation

Dave joined NCIS on October 1, 1996 as a Crop Insurance Specialist. He became Director of the MPCI Department in 1997 and has served as Director, Program Evaluation since July, 2001. Dave is originally from Nebraska and came to NCIS with a farm background and 17 years of crop insurance experience which included MPCI and Crop-Hail loss adjustment of claims and field supervisory duties as well as audits, reviews, and agent and adjuster training activities.

Linda Kovelan

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Linda has worked for National Crop Insurance Services for 6 ½ years, presently as Actuarial Applications Specialist and Executive Assistant to the Executive Vice President. She assists in the crop-hail actuarial state filings to the crop insurance industry. Linda has also worked for Everpure, Inc., division of Culligan International for 8 years in the Sales and Marketing Department as Administrative Assistant and Manager of Customer Service. Linda graduated form Bowling Green State University, Bowling Green, Ohio in 1975 with a B.A. in Business Education and A.A. in Office Management. She has taught business classes through continuing education.