STANDARD REINSURANCE AGREEMENT FREQUENTLY ASKED QUESTIONS
UPDATED FOR SECOND DRAFT - MARCH 12, 2010

1. How did RMA determine changes offered in the second draft of the Standard Reinsurance Agreement (SRA)?

As intended, RMA considered comments and recommendations from participating crop insurance companies and other stakeholders to develop the provisions of the second draft. The second draft incorporates several ideas of the companies, while complying with the 2008 Farm Bill's directive to effectively address the significant rise in Government expenditures and ensure the continued strength of the Federal crop insurance program delivery system. Our objectives remain the same:

- Maintain producer access to critical risk management tools;
- Align Administrative and Operating (A&O) subsidy closer to actual delivery costs;
- Provide a reasonable rate of return to the companies;
- Protect producers from higher costs while equalizing reinsurance performance across states to more effectively reach underserved producers, commodities and areas;
- Simplify provisions to make the SRA more understandable and transparent; and
- Enhance program integrity.

With the second draft, we will be able to achieve these objectives and, at the same time, address a number of concerns voiced by the companies. As a result, the new SRA will continue to serve as a solid foundation for the effective delivery of Federal crop insurance. And it will do so in a prudent, cost effective, and sustainable manner for farmers, the insurance companies, and taxpayers**.**

2. What changes to A&O payments are in the second draft?

A&O subsidies are payments made to companies on behalf of the policyholder to cover the cost of selling and servicing the policy. As with the first draft, the second draft provides companies with relatively stable A&O subsidies per policy for seven major commodities and will facilitate insurance company planning. RMA has noted company concerns and responded by adopting the following major changes:

- The second draft incorporates a two year transition period for companies to fully adjust to the new A&O subsidy structure. During the transition, the reference price will be 10 percent higher in 2011 and then 5 percent higher in 2012 until base references prices are reached for 2013. This provision

was added in response to company concerns that they needed time to adjust their business models to the new A&O structure.

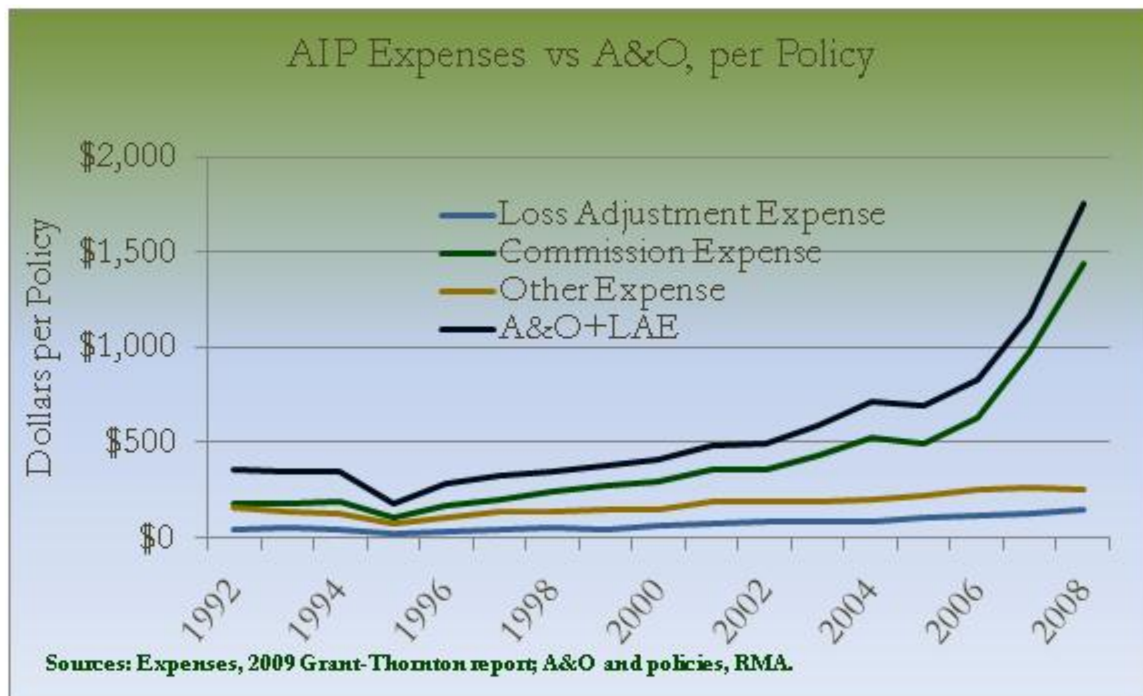
- Providing for 5 percent higher reference prices for underserved and less-served States (State Groups 2 and 3). This provision will provide an additional financial incentive for companies to either start or continue to do business in more underserved or less-served areas, thus helping ensure farmers all across America have access to important risk management tools.
- In response to concerns raised by the companies, the second draft has a new provision that will limit companies' expenditures on acquisition costs (agent commissions) to 80 percent of A&O per policy. Companies will still be allowed to use profit sharing to pay agents above this limit.

3. Why did RMA cap base agent commissions in the second draft?

This provision responds to calls from Members of Congress, academia, government accountability organizations, and the insurance companies themselves to moderate the unsustainable growth in agent commissions. In particular, the US Government Accountability Office (GAO) report (GAO-09-445, "Crop Insurance: Opportunities Exist to Reduce the Costs of Administering the Program") indicated that commissions had risen by alarming rates between 2006 and 2007. This report also highlighted the strong linkage between elevated agent commissions and destabilizing market practices, such as illegal rebating. RMA is also aware that companies have been subsidizing the funding of rising base agent commissions in the Corn Belt by shifting A&O subsidy from lesser-served areas, leading to reduced service and accessibility for some producers.

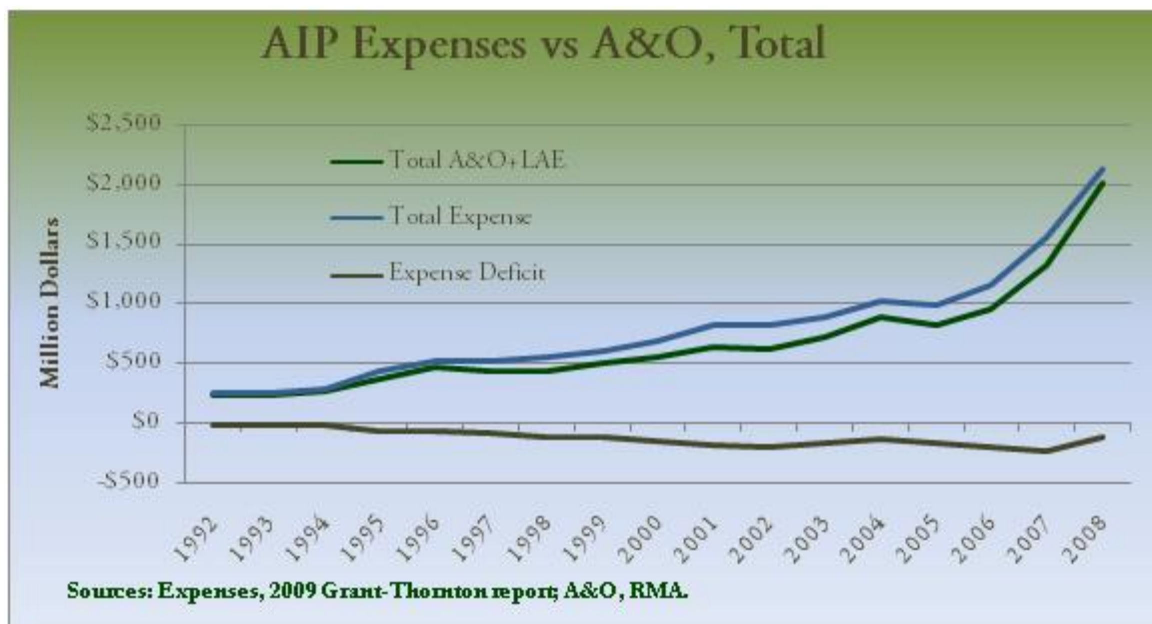
The companies' own data, through its Grant-Thornton study, show that agent commissions are growing at an unsustainable rate (See Chart 1). Company expenditures for loss adjustment, training, overhead, information technology and other expenses have shown only modest increases over the past few years, but agent commissions have increased exponentially.

Chart 1



Please refer to Table 1 for data supporting Chart 1

Chart 2



Please refer to Table 2 for data supporting Chart 2

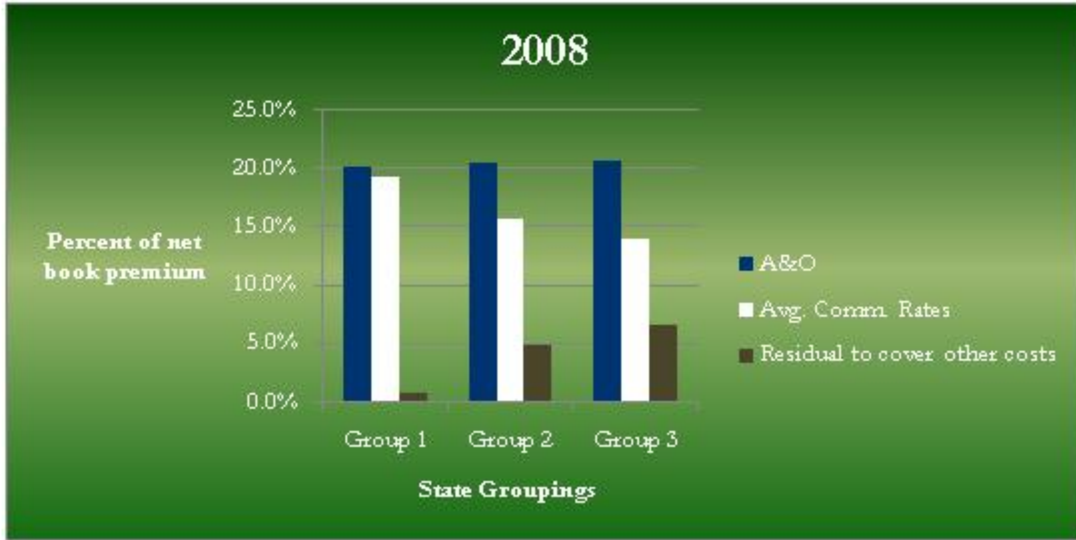
In 2008, the average company expenditure for loss adjustment, training, and all other expenses (excluding agent commissions) was only slightly over $400 per policy according to the industry's study. Agent commissions in 2008, however, averaged almost $1,450 per policy. Even as the amount of A&O paid to the companies more than doubled between 2006 and 2008, the companies still managed to run an expense deficit because of runaway agent commissions in the Corn Belt (See Chart 2).

In fact, in 2009, *average* agent commission rates in the Corn Belt (Group 1 States) were 18.6 percent of premium and the A&O paid to the companies was 17.1 percent, meaning the companies paid *108.8 percent* of their A&O subsidy to agents in this area (See Chart 4). In comparison, average commission rates in the Group 2 States were 15.2 percent, representing 81.7 percent of A&O, and average rates in Group 3 States were 13.2 percent, representing 71.0 percent of A&O.

Additionally, while some of the A&O reductions from the 2008 Farm Bill were passed on to agents, companies were still left to potential financial insolvency. In the Group 1 States, A&O decreased from 20.2 percent of premium in 2008 to 17.1 percent in 2009, while the agent commission rate dropped from 19.3 percent to 18.6 percent. Thus, the companies had *-1.5 percent* left to pay for loss adjustment, training, and all other costs in the Corn Belt. To make up this difference companies have relied upon the assumption that they would have large underwriting gains and shifted some portion of A&O payments from other states to pay agent commissions in the Corn Belt.

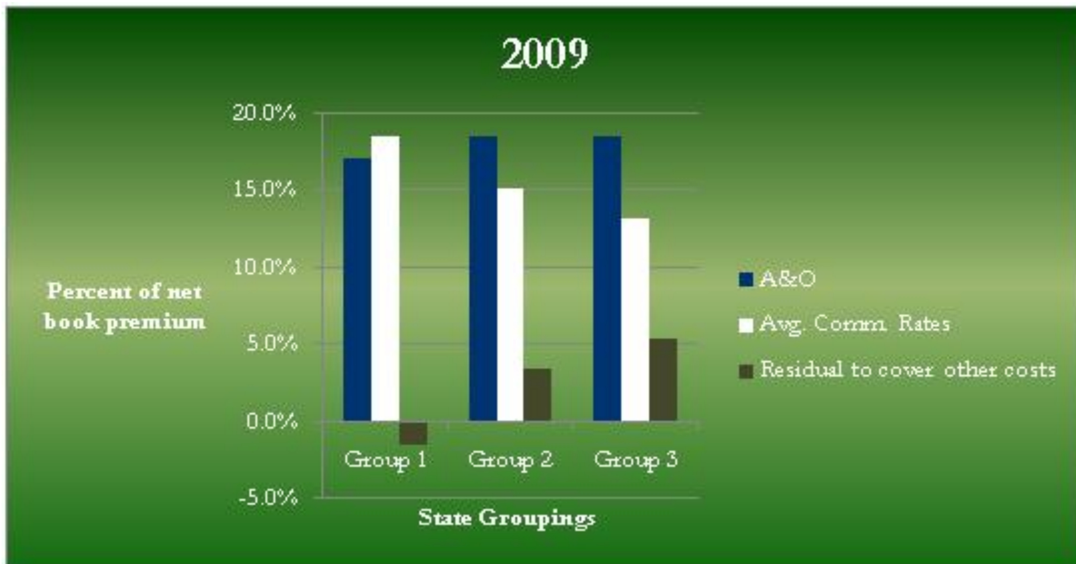
During the SRA negotiations, several crop insurance companies suggested that the program find ways to assist in moderating excess agent commissions. In particular, several companies advised assistance was needed to help ensure financial solvency in the future. The 2002 failure of the then largest company in the program illustrates these concerns. A primary cause of this company's failure was that it was paying agents significantly more than it received in A&O, under the assumption that it would make enough on underwriting gains to pay for it. However, a year in which large underwriting gains are not realized can easily pressure a company's financial position ultimately leading to a company going out of business, as happened with the largest company in 2002. This provision will help minimize the potential for a company to go bankrupt because it is making unsustainable commitments to its agents.

Chart 3 – 2008 Comparison of A&O to Agent Commissions by State Group



Please refer to Table 3 for data supporting Chart 3

Chart 4 – 2009 Comparison of A&O to Agent Commissions by State Group



Please refer to Table 4 for data supporting Chart 4

Under this provision, companies will still be allowed to share underwriting gains with agents, which can raise total agent compensation to more than 80 percent of the A&O per policy. But if the company does not make an underwriting gain, there are no profits to share with agents. As a result, the company is prevented from jeopardizing its future solvency by committing too much of its expected income to agents.

4. What changes does the second draft make to its risk sharing provisions?

Through its risk sharing terms (underwriting gains and losses), the second SRA draft preserves RMA's rebalancing efforts to more effectively reach underserved and less-served producers, commodities, and areas. Insurance companies generally supported this effort but with modifications adopted as follows:

- The second draft modifies the Residual Fund (described later in question 18) so that each company has one Residual Fund nationwide, instead of the fund being shared nationally across all companies. This addresses a major company concern that they would be held accountable for other companies' policies. The Residual Fund will still spread out risk because it is a national fund, compared to the current assigned risk fund, which is operated on a state basis. In the second draft, each company retains 50 percent of premium and liabilities of its national Residual Fund, down from the first draft where companies retained 100 percent of premium and liabilities in the first draft Residual Fund.

- In the first draft, the states were divided into four groups in the Commercial Fund (described in question 19) according to each State's historical underwriting performance. This provision seeks to equalize reinsurance performance geographically and provide companies with a financial incentive to sell and service underserved and less-served areas. The second draft reduces the number of state groups from 4 to 3 for simplification. A separate group – Group 3 – has been established for underserved or less-served States (described in question 20).

- Group 1 represents the 5 States with the highest levels of expected return under the current SRA. Under the first draft the reinsurance terms were restructured to be less generous than the current SRA. The second draft modifies these terms to be more generous than the first draft, but not as generous as the current SRA. The other 45 States (Groups 2 and 3) will receive more generous reinsurance terms compared to the current SRA.

- The Net Book Quota Share is reduced from the 10 percent proposed in the first draft to 7.5 percent, with 2.5 percentage points of any underwriting gain to be distributed to those that sell and service policyholders in 17 underserved/less-served States (Group 3 States). This will provide another financial incentive for companies to do business in these historically underserved or less-served States. This provision will also be consistent for the entire 5 years of the new SRA, which is in response to suggestions by the companies, so that that they can make long-term plans and investments in these States.

5. What are the three state groupings in the second draft?

"State Group 1" includes Illinois, Indiana, Iowa, Minnesota, and Nebraska.

"State Group 2" includes Alabama, Arizona, Arkansas, California, Colorado, Florida, Georgia, Idaho, Kansas, Louisiana, Michigan, Missouri, Mississippi, Montana, North Carolina, North Dakota, New Mexico, Oklahoma, Kentucky, Ohio, Oregon, South Carolina, South Dakota, Tennessee, Texas, Virginia, Washington, and Wisconsin.

"State Group 3" includes Alaska, Connecticut, Delaware, Hawaii, Maine, Maryland, Massachusetts, Nevada, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Utah, Vermont, West Virginia, and Wyoming.

6. What changes does the second draft make to the $100,000 claim review process?

Currently, the companies are required to review all claims over $100,000. This is a quality control measure recommended by the Office of the Inspector General intended to provide a reasonable assurance to the taxpayer that the information on the policy is accurate and the loss to be paid on the claim is

correct. A key element in the company's review consists of verifying the information pertaining to the actual production history (APH) to determine whether the claim can be substantiated.

The number of $100,000 claim reviews has increased in recent years with increased commodity prices and increased guarantees. However, it still represents a very small percentage of all claims.

Under the current SRA and the first draft, adjusters were required to verify a full three years of APH information for APH reviews. The second draft SRA modifies and simplifies the APH claim review process for producers and companies. To comply with $100,000 claim review requirements under the second SRA draft, an adjuster will verify the producer's data for the most recent year. If this information is accurate and the adjuster can confirm that the producer has adequate prior years' information that appear to support the APH certified by the producer, then the APH verification requirement will be satisfied. If there are problems with the current year, then the adjuster will need to review prior years. Through the second draft, the APH review process will be simplified, while continuing to be an effective tool to ensure program integrity.

7. How will this negotiation affect farmers and ranchers?

The SRA has nothing to do with the premiums paid by farmers and ranchers for Federal crop insurance. Any changes to the premium subsidy percentages require Congressional action. Therefore, no farmer or rancher will see increased premium costs because of this new agreement. Many farmers and ranchers will not see any change in their crop insurance products, costs, or levels of service. Those that do see a change – primarily underserved and less-served farmers and ranchers – are expected to receive increased crop insurance opportunities resulting from new financial incentives for insurance companies to expand the availability of crop insurance to new areas. Managing risk is critical for all producers and every farmer and rancher deserves access to this important national program.

One of RMA's key objectives in the SRA is to ensure that producers have expanded access to important risk management tools. The draft SRA stabilizes the Federal crop insurance program, reducing volatility in returns to companies and ensuring that farmers will continue to have access to the program.

This agreement will produce a more stable, more widely accessible, and equally affordable crop insurance program for farmers. When negotiations are complete, we expect to have a stronger Federal crop insurance program that helps producers better manage their risk and that serves farmers in every region of the country.

8. Why does crop insurance need reform when the program is successful at providing risk management for producers and the participation rate for major crops is over 80 percent?

The Federal crop insurance program has been enormously successful because of the public-private partnership, and companies and their agents and loss adjusters should be commended for their efforts. Against the backdrop of the crop insurance program's success and increased participation levels, however, are serious concerns that the program's success has recently come at an unsustainable price for taxpayers. Government expenditures to insurance providers for the A&O subsidy and companies' share of underwriting gains have more than doubled in recent years – from $1.8 billion in 2006 to $3.8 billion in 2009 – at a time when the number of policies serviced has actually declined as farm operations consolidate (See Chart 5). The new draft SRA restructures these expenditures so that the potential for such significant increases in the future will be mitigated while ensuring that farmers and ranchers continue to get the service they deserve.

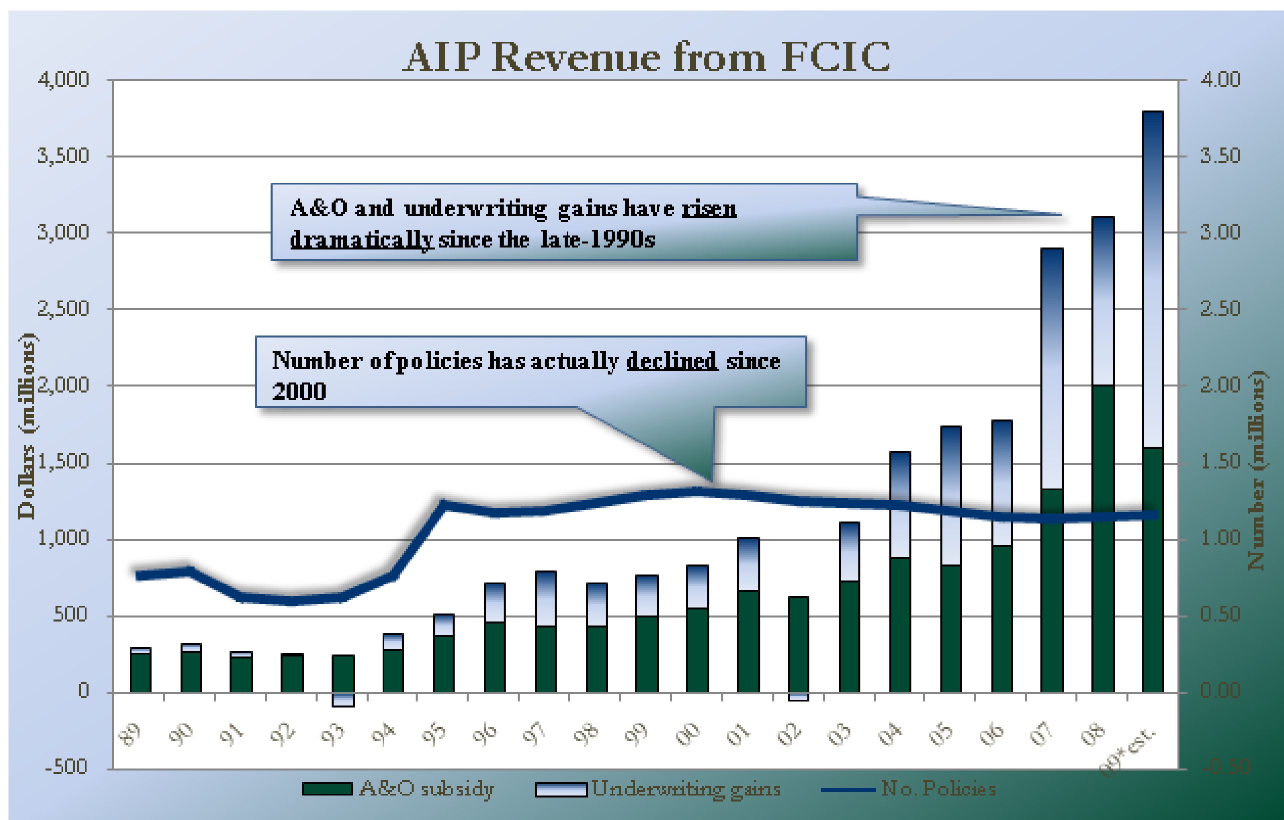
9. Why does crop insurance need reform, when Congress reformed parts of the program in the 2008 Farm Bill?

The 2008 Farm Bill made limited program cuts to address immediate and obvious program expenditure excesses but gave RMA the authority to renegotiate the SRA to achieve more permanent solutions to the program expenditure problems. It specifically directed RMA to consider alternative methods to determine rates for A&O payment to companies, a payment made on behalf of producers for the selling and servicing of the policy. In other words, the 2008 Farm Bill directed RMA to further reform the Federal crop insurance program through SRA negotiations.

Moreover, we have seen dramatic increases in Government expenditures to the companies since the Farm Bill discussions took place and the 2008 Farm Bill language was finalized. Total A&O subsidy expenditures for 2006 were $959 million, a level that motivated Congress to reduce the subsidy rate for the upcoming reinsurance year in the Farm bill. Actual A&O subsidy expenditures for 2009 are estimated to be $1.6 billion, a 65 percent increase over 2006. Additionally, underwriting gains for the companies increased by an even greater amount – 260 percent – from $822 million in 2006 to $2.2 billion projected for 2009.

Together, A&O and underwriting gains have more than doubled in the last 3 years, from $1.8 billion in 2006 (at the beginning of the 2008 Farm Bill debate) to an estimated $3.8 billion in 2008 and again in 2009, while the number of total policies decreased from 1.3 million in 2000 to 1.2 million in 2009 (See Chart 5). In today's challenging fiscal environment, these developments are unsustainable.

Chart 5



Please refer to Table 5 for data supporting Chart 5

10. Why did Government expenditures to crop insurance companies increase so much in recent years?

The significant rise in Government expenditures has been driven primarily by rising commodity prices and ongoing improvements to the program that have significantly benefitted companies.

Under the current agreement, A&O payment is based solely on premium costs, which are directly influenced by commodity prices. They are not in any way tied to the underlying cost of selling and servicing a crop insurance policy. As commodity prices rise and decline, premiums change, causing proportional changes in the amount of A&O payment provided by the Federal Government. Thus, as commodity prices have spiked in recent years, so too have A&O payments to companies. But, these changes in commodity prices have virtually nothing to do with changes in the cost of selling and servicing Federal crop insurance policies.

As recently as 2006, A&O payments were well below $1 billion annually and the average payment per policy in 2006 was about $835. And, this amount of money was more than adequate to provide for effective delivery of the program. By 2008, A&O payments had increased to over $2 billion (over $1,750 per policy). This significant increase was due almost entirely to commodity price increases and other factors that have little impact on the cost of selling and servicing policies. Under the current agreement, A&O payments are projected to remain above $1.5 billion through 2015 (around $1,300 per policy) because of continued high commodity prices (See Chart 6).

Companies can also earn profits from underwriting gains or suffer losses when they assume risks. Underwriting gain and loss sharing (reinsurance) provisions establish how premium and claims payment dollars are shared between USDA and the insurance companies. When premium collections exceed claim payments, an underwriting gain is earned; conversely, an underwriting loss is suffered when claim payments exceed premium collections. The current structure was established in an era when loss ratios were relatively high—averaging above 1.4. The structure established then, which is still basically in place, was designed to ensure that companies were able to earn a reasonable profit for the risks they assumed at a time when the program itself was losing money.

Since then, actuarial improvements to the program and other factors have led to significantly lower loss ratios—now averaging less than 1.0. Companies have benefited significantly from this dramatic program shift by seeing their underwriting gains rise from $822 million in 2006 to $2.2 billion projected for 2009, a 260 percent increase.

Together, the two components of Government expenditures to companies—A&O subsidy and underwriting gains to companies—have risen from $1.8 billion in 2006 to $3.8 billion in 2009, a 111-percent increase.

11. What is a "reasonable rate of return" for crop insurance companies?

RMA used sound economic and insurance principles in determining reasonable levels for Federal crop insurance program expenditures to companies. RMA considered several reports and studies, including a Government Accountability Office study GAO-09-445 "CROP INSURANCE: Opportunities Exist to Reduce the Costs of Administering the Program," which identified causes for the dramatic increases in the A&O subsidy in recent years and recommended alternatives for its stabilization.

RMA also contracted for two studies by Milliman, Inc. (Milliman), a private consulting firm. Milliman's findings are contained in two reports—the "Historical Rate of Return Analysis" and a "Rate of Return Update 2008: Reasonable Rate of Return," both posted on RMA's website. To determine how payment amounts translate into company profitability, Milliman used a proven methodology for determining after-tax returns on equity resulting from crop insurance business for the companies in the program. Milliman's approach is rigorous, and consistent with that used by many Government regulatory authorities –

including those charged with regulating insurers. Milliman's objectivity and experience in this area is supported by the fact that it has completed similar assessments for private insurance companies as well as Government regulators.

Milliman's "Historical Rate of Return Analysis" calculates actual rates of return over the last 20 years, expressed in terms that can be directly compared to the reasonable rate of return.

Milliman's "Reasonable Rate of Return" study derives the annual rate of return that the companies should be expected to earn to equal earnings from alternative investment opportunities relative to the risk assumed. (Also known as the industry cost of capital.) This calculation serves as the benchmark return against which actual returns can be compared to determine profitability.

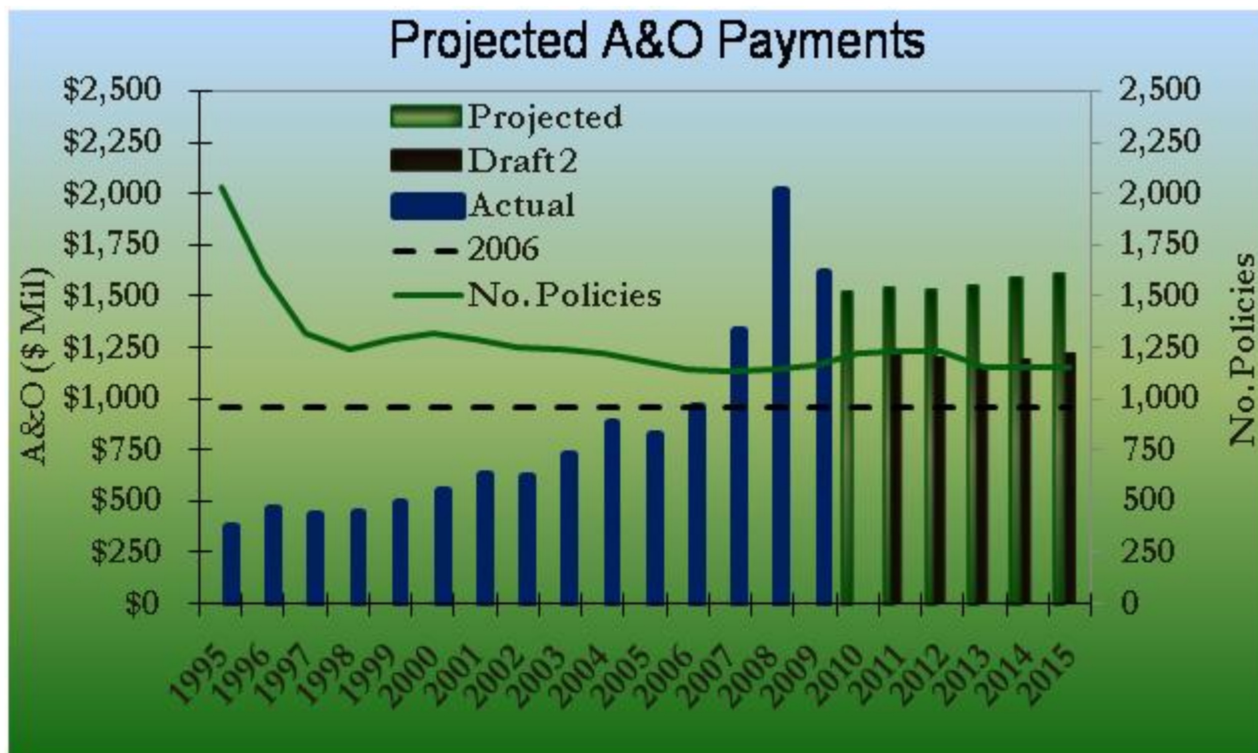
The Milliman studies indicate that, over the last 20 years, the "reasonable rate of return" for crop insurance companies averaged 12.8 percent, while the companies actually received an average rate of return of 16.6 percent. Preliminary analysis further indicates that the rate of return for companies for 2009 will be approximately 25 percent, well in excess of the estimate for a reasonable rate of return of about 12 percent.

12. What timeframe did Milliman use to determine its historical rate of return?

Milliman looked at data from 1989 to 2008 in its Historical Rate of Return study. The Data Acceptance System (DAS) used by RMA to monitor policy-level crop insurance data was established in 1989. The time period analyzed by Milliman encompasses the entire DAS data set currently available at RMA. The Milliman analysis reflects the longest historical data set of all studies currently available on crop insurance company profitability.

Milliman acknowledged in its report that surveying only 20 years limits the conclusions one may draw as to the likelihood of potential catastrophic events. To consider this possibility more fully, it performed a hypothetical analysis in which the 20-year span includes a second "disaster" year, similar to that of 1993 in place of an average year. The result of this hypothetical exercise is an average historical rate of return, which still exceeds the reasonable rate of return by 2.3 percent.

Chart 6



Please refer to Table 6 for data supporting Chart 6

13. Will the companies' A&O subsidy be "cut" under the new draft SRA?

The "cut" in A&O subsidy is a reduction only from the inflated amounts of recent years – which was all due to the spike in commodity prices. Had the price spike not occurred, the amount of A&O provided under the draft SRA would be widely regarded as reasonable. RMA is proposing to restructure the A&O subsidy to effectively neutralize the impact of high commodity prices and year-to-year volatility for major commodities on the amount of A&O provided to companies. The purpose is to eliminate the A&O windfall of recent years and, as importantly, ensure that an adequate A&O subsidy is provided to companies so that the delivery of Federal crop insurance to producers is not jeopardized. Therefore, the average amount of A&O subsidy per policy under the second draft of the SRA will be about $1000 per policy, a significant increase above the $835 average per policy in that was paid out in 2006 (See Chart 6). It is important to note that this estimated increase per policy also incorporates the changes made in the 2008 Farm Bill.

RMA is confident that these changes provide the companies with the resources needed to deliver the program. And, because the A&O subsidy will be less vulnerable to erratic commodity price changes, companies and their agents will enjoy more stable and dependable subsidies in the future to support the cost of delivering the program.

14. Will the new agreement provide enough A&O to cover delivery costs?

Yes. In the first draft, RMA has ensured that companies will receive a stable and reasonable amount to deliver the program. Under the second draft SRA, the A&O will be about $1000 per policy over the next

5 years, which is significantly higher than the $835 average per policy in 2006, and is more than adequate to deliver the program effectively (See Chart 6).

RMA does recognize that regulation from the Government since the last renegotiation has added some costs to company operations; however, these additional costs are not commensurate to the increase in the overall A&O subsidy per policy and are largely offset by the implementation of increasingly automated processes – such as quality control process. The new draft SRA simplifies the agreement in several ways, making the program easier to understand and deliver for the insurance companies and their agents. The companies are also given more flexibility in their training requirements.

In 2008, the average company expenditure for all expenses other than agent commissions was only slightly over $400 per policy according to the industry's own Grant-Thornton study (See Chart 1 above). The proposed SRA would provide an average A&O subsidy of about $1,000 per policy, well above the $400-$500 per policy the industry's own study indicates is needed for claims handling, training, and other expenses. The main costs that the companies will need to control are the rapidly increasing agent commissions (See Chart 1). The second draft helps the companies do this by providing a soft cap on commissions.

Some companies have suggested that they would suffer a net loss under the proposed SRA terms, as compared to a profit under the current SRA. However, the example assumes that its expenditures for commissions remain at alarmingly high levels, suggesting no change in how commission funds are spent although the total amount provided will be less. Companies that would continue to pay commissions at this rate would leave themselves extremely vulnerable if commodity prices were to drop or if they were to have a bad year.

During the last renegotiation, the crop insurance companies stated similar concerns that they would be forced to drop out of the program if changes were made to the A&O subsidies. In contrast, companies have seen record profits since the signing of that agreement, new companies were accepted into the program, and still more entities are petitioning for admittance, even with the proposed new agreement pending.

15. How will the A&O subsidy adjust with inflation?

The A&O subsidy will be based on a 10-year average price, or reference price, for seven major commodities. This reference price will be based on the years 1999 to 2008. For these major commodities, the reference price will be phased in for 2011 and 2012, then locked in and will not change with for the duration of the agreement. In addition, States within Groups 2 and 3 (See Question 16) will receive a 5-percent premium to further provide incentives for companies to provide service in underserved and less-served States. The A&O subsidy for over 115 other crops will continue to float with their respective prices.

Although the major commodity reference prices will not be indexed to inflation, the A&O subsidy, both in dollar and per policy terms, is expected to rise with the persistent, long-term uptrend in crop yields. As yields rise, liability and premiums rise, thereby increasing the base on which the A&O subsidy is calculated.

16. How will the proposed SRA affect the business models of the companies?

We believe that without fundamental changes to the delivery system, the Federal crop insurance program could be headed toward serious problems.

As Chart 1 clearly illustrates, the industry's own Grant-Thornton study shows that agent commissions are growing at an unsustainable rate. Further, these data show that it does not matter how much the Government pays the companies for program delivery, they are still likely to run deficits. Even as the

amount of A&O paid to the companies more than doubled between 2006 and 2008, the companies still managed to run an expense deficit because of runaway agent commissions. The second draft SRA, by providing relatively stable A&O payments and providing a soft cap on agent commissions, will allow for a more sustainable delivery system in the future, protecting producers, companies, and taxpayers.

17. What are reinsurance funds and how are they changed in the draft SRA?

In order to reinsure their risk, companies place the insurance policies they write into various reinsurance funds according to their expected riskiness. Different underwriting gain and loss sharing (reinsurance) provisions in the SRA for these funds then establish how premium dollars are shared between USDA and the insurance companies to the extent that insurance premiums received either exceed or are less than claims paid. The actual sharing of gains and losses involves relatively complex calculations of proportional and non-proportional risk sharing determined by the reinsurance fund to which the policy is assigned by the company, the state in which the policy is written, and the category of insurance plan written.

The new draft SRA makes several significant changes to the reinsurance funds and their terms, including several changes to simplify the reinsurance terms. The current SRA includes three main funds which companies can place policies in order to reinsure their risk. These are the Commercial Fund, the Developmental Fund, and the Assigned Risk Fund. Companies place policies they determine to be riskiest in the Assigned Risk Fund, those they see as safest in the Commercial Fund, and those with medium risk in the Developmental Fund. The current SRA also includes three subfunds for the Commercial and Developmental Funds that differentiate between plans of insurance.

Therefore, the current structure establishes seven distinct funds on a state basis, resulting in a potential total of 350 funds nationwide for each company, with each of the 350 funds potentially having its own reinsurance structure.

The new draft SRA simplifies these terms by reducing the total number of potential funds from 350 to 51. The first draft SRA provided for one Commercial Fund in each of the 50 States and one nationwide Residual Fund, for a total of 51 potential funds. The second draft SRA provides for a Residual Fund, by company, on a nationwide basis, in response to company concerns that they did not want to be responsible for other companies' loss performance.

18. What is the Residual Fund?

In the new draft SRA, the state-based Assigned Risk Fund and the scarcely used Developmental Fund are replaced with a single, nationwide Residual Fund for each company. The Residual Fund will provide stability to the program by pooling risk and spreading it more evenly geographically. Companies will have the opportunity to place their riskiest policies in this nationwide pool. Therefore, risk will not be concentrated in one area of the country, but will be more widely distributed.

19. What is the Commercial Fund?

The draft SRA includes reforms to the Commercial Fund in order to level the playing field across rural America. First, the three current Commercial subfunds are consolidated into one fund per state. The draft SRA also differentiates the gain and loss sharing structure according to state groupings. The States are divided into groups according to each State's historical underwriting performance. The result is a new structure that will tend to equalize reinsurance performance geographically. This, in turn, will provide companies with a financial incentive to sell and service policies in areas of the country that have historically been neglected because companies have expected less underwriting gains in those areas.

In the second draft SRA, the states are divided into three groups (listed in question 5). For the purposes of the Commercial Fund, State Groups 2 and 3 have the same reinsurance terms, so there are effectively only

2 groups in the Commercial Fund. Group 3 is differentiated entirely for the purposes of the new Net Book Quota Share provisions.

In the first draft SRA the Commercial Fund was structured so that the Government would assume a greater share of extreme gains or losses in a state. This feature was added to provide stability to the program by giving companies greater protection in the event of a significant and widespread weather event. In the second draft SRA, the Commercial Fund terms are revised to be more generous in terms of profit potential, as companies indicated they desired more risk in return for more profit potential.

20. What is Net Book Quota Share?

The Net Book Quota Share is the proportion of a company's overall gain or loss that is ceded to the Government after all other reinsurance provisions in the SRA have been applied. Under the current SRA, this proportion is 5 percent. The first draft SRA raised this to 10 percent, but returned up to 5 percentage points of any underwriting gain to the companies selling and servicing producers in established target market areas or crops determined each year as to greatest need within the program.

The second draft SRA establishes the Net Book Quota Share at 7.5 percent. However, the "giveback" is fixed at 2.5 percent of any underwriting gain and will be distributed back to those companies who sell and service policyholders in 17 underserved/less-served States (Group 3 States), according to the premium generated in those States. Companies would not be able to receive more than their total A&O paid for those States. In other words, this provision could provide companies with a financial incentive for servicing underserved/less-served States that is up to the same amount they receive in A&O for those States. This would provide a substantial financial incentive for companies to reach underserved/less-served areas.

21. What would happen to the companies in a bad year under the new agreement?

The new agreement will provide companies with significantly more protection from losses in bad years. The crop insurance program can be marked by volatility, and the industry is vulnerable to unforeseen weather events.

Currently, A&O subsidies provided to the companies fluctuate with changes in commodity prices, meaning that steep declines in commodity prices leave companies with less money to run the program. The new draft SRA delinks A&O subsidies from price fluctuations for the major commodities. This means that the companies will be guaranteed an A&O higher than they received in 2006 or any prior year.

The companies also currently purchase commercial reinsurance to protect themselves from catastrophic losses. Under the reinsurance terms of the new draft SRA, the Government will now take on more of the catastrophic risk, with the remaining risk spread out more evenly to all companies. This will provide more protection in bad years and reduce dependence on commercial reinsurance.

As a regulator, RMA performs a rigorous financial analysis each year on each company to ensure that it has the financial capacity to withstand 2 consecutive years of significant losses. With the new proposed structure, volatility of earnings will be reduced, giving the companies a more predictable and level rate of earnings. An RMA stress test analysis indicates that companies would have fared much better in bad years under the terms of new agreement, especially if there are 2 bad years in a row.

This added stability will reduce the likelihood that companies will be financially jeopardized after a bad year. With financially stable private companies, America's producers can be assured of full crop insurance opportunities and uninterrupted service.

22. These are tough economic times. How will the SRA help protect jobs in rural America?

The new draft agreement provides companies with more stable subsidies and increased earnings protection. These changes will result in more stability for agents, loss adjusters, company employees and others in rural America that are affiliated with and dependent on the crop insurance industry.

The new agreement will also expand the program to new areas in rural America by providing new financial incentives to companies to reach areas in which there are currently few companies and few agents selling policies. This expansion will provide more financial stability to farmers and ranchers by providing them with better access to these risk management tools.

23. How will the agreement affect the "Corn Belt"?

The Corn Belt has been the most profitable area for crop insurance companies because of the unique pattern of production losses for major commodities in that area (See Chart 7 & 8, with explanation below). Production losses of corn and soybeans in the Corn Belt are typically low frequency/high severity events (for example, a large flood or drought every 10-15 years or so, but otherwise very good years). With this loss pattern under the current SRA, companies earn significant returns during the good years whereas the Government picks up most of the extreme losses in the infrequent bad years.

By contrast, many other areas experience high frequency/low severity events. Such production loss patterns are far less profitable for companies under the current SRA because the companies: (a) pick up losses more frequently; and (b) take on a proportionately larger share of the losses because the losses are typically not large enough to trigger significant Government "stop loss" protection.

The geographical differences in loss patterns have resulted in serious problems in both the Corn Belt and elsewhere under the current SRA structure. In the Corn Belt, the concentration of companies and agents seeking the relatively fixed, but highly profitable crop insurance business within this limited area has become so intense that marketplace stability has been seriously threatened. The recent GAO report (GAO-09-445, "Crop Insurance: Opportunities Exist to Reduce the Costs of Administering the Program") highlighted the strong linkage between high underwriting gains, elevated agent commissions, and destabilizing market practices such as illegal rebating. Such activities are concentrated within the Corn Belt and have become serious enforcement problems for both state and Federal regulators.

Indeed, the 2008 Farm Bill recognized the prevalence and seriousness of such problems and imposed stricter rebating language into the law, reduced previously available opportunities to rebate by cooperative associations, and introduced a Controlled Business provision to help address these problems.

The new draft makes changes to the reinsurance terms to reduce this effect and thereby equalize the servicing of crop insurance across America, regardless of the expected pattern of production losses. After these changes, companies will continue to provide good service to producers in the Corn Belt because they can continue to expect reasonably profitable, but not excessive, underwriting results. Companies, their agents, and producers will also benefit from a more stable marketplace because there will be less financial incentive to engage in disrupting and illegal marketing practices.

24. Can't rebalancing be accomplished through the revision of premium rates?

The difference in underwriting gains across states is due to their differing risk profiles. The two graphs below show the loss ratios for Iowa (a high-return State) and Texas (a low-return State) based on historical state-level NASS yield data for the major crops; corn, cotton, rice, sorghum, soybeans, and wheat. These major crops account for most of the crop insurance in these States. The use of NASS data, rather than RMA data, avoids any issues about changes in the crop insurance program or participation over time and allows a longer time series to be considered. As it turns out, RMA's historical data yields similar results to what is presented here. The premium rates for both States are set such that the average loss ratio for the 1958-2009 time period is 1.00. In other words, the premium rate in both States is actuarially sound.

The graphs show the different risk profiles of Iowa and Texas. Significant losses in Iowa tend to be infrequent, but are extremely severe when they occur. Loss ratios are generally below 1.00 for years at a time, punctuated by catastrophic losses. In contrast, significant losses occur with much greater frequency in Texas, but the losses are less catastrophic. Thus, loss ratios in Texas tend to exceed 1.0 far more often than in Iowa.

Chart 7

Please refer to Table 7 for data supporting Chart 7

Chart 8

Please refer to Table 8 for data supporting Chart 8

The difference in risk directly results in very different returns under the current SRA. Applying the state loss ratios to the risk-sharing terms of the Commercial Fund in the current SRA results in an average return of 17.5 percent for Iowa, but only a 7.2 percent return for Texas. The difference in returns is because the current SRA provides companies much more protection against catastrophic losses than it does for minor losses.

In the current SRA, the Government absorbs most of the loss that exceeds 2.20 (as signified by the dashed line) and companies absorb most of the risk below 2.20. The loss ratio in Iowa exceeds 2.20 several times (and by a significant margin), indicating that the Government absorbs much of the loss on behalf of the companies in these cases. However, the loss ratios in Texas do not exceed 2.20 to any significant degree, indicating that insurance companies absorb most of the losses. The Government absorbs much more of the losses in Iowa than in Texas, resulting in higher returns in Iowa than in Texas.

The current SRA, with its one-size-fits-all approach of offering the same risk-sharing terms in all states, produces larger underwriting returns in states with infrequent, but severe, losses like Iowa than it does for those states with frequent, but not severe, losses like Texas.

The Draft 2011 SRA recognizes this inherent difference in risk across states and offers different risk-sharing terms for states like Iowa than for other states. This will reduce the large disparity in returns that occurs under the current SRA.

25. How will the agreement affect the rest of rural America?

The draft SRA contains a number of features that are designed to expand the availability of crop insurance to places where there are currently few companies and agents selling policies, while ensuring that a high level of service will be maintained for those who have come to depend on it. The draft SRA expands the availability of crop insurance by providing insurance companies with additional financial incentives to service those areas, producers, and operations that lack some of the product availability and quality service that many of the Corn Belt and other major crop producing states enjoy. The draft SRA rebalances the program's underwriting performance to level the playing field across the U.S. by dividing the states into groups in the Commercial Fund and improving the reinsurance terms for underserved and less-served States.

The new agreement will provide Group 2 & 3 States (all states other than the Corn Belt) with 5-percent higher reference prices, which will lead to higher A&O subsidies for these less-served States. Also, the draft SRA contains a provision to "profit share" a portion of the Net Book Quota Share with those insurance providers that sell policies and service underserved or less-served States.

Together, these provisions will provide strong financial incentives for companies to foster enhanced service in underserved and less-served areas.

Chart 1 – AIP Expenses vs A&O, Per Policy

Year	Loss Adjustment Expense	Commission Expense	Other Expense	Expense Surplus or Deficit	A&O+LAE
1992	$ 48.25	$ 183.80	$ 156.23	$ (25.85)	$ 362
1993	$ 60.08	$ 186.92	$ 133.52	$ (22.50)	$ 358
1994	$ 46.29	$ 201.76	$ 122.24	$ (18.06)	$ 352
1995	$ 29.72	$ 113.55	$ 74.68	$ (30.90)	$ 187
1996	$ 41.01	$ 181.14	$ 107.09	$ (37.28)	$ 292
1997	$ 45.92	$ 210.68	$ 143.15	$ (65.41)	$ 334
1998	$ 55.86	$ 250.60	$ 138.89	$ (88.24)	$ 357
1999	$ 55.62	$ 278.11	$ 143.54	$ (88.84)	$ 388
2000	$ 67.12	$ 304.93	$ 151.50	$ (106.29)	$ 417
2001	$ 84.92	$ 360.34	$ 185.91	$ (141.25)	$ 490
2002	$ 97.10	$ 365.27	$ 194.20	$ (159.63)	$ 497
2003	$ 91.34	$ 440.09	$ 190.98	$ (131.45)	$ 591
2004	$ 95.39	$ 531.47	$ 204.41	$ (107.50)	$ 724
2005	$ 109.36	$ 503.70	$ 218.71	$ (135.28)	$ 696
2006	$ 118.98	$ 640.05	$ 254.38	$ (178.24)	$ 835
2007	$ 132.37	$ 978.39	$ 264.74	$ (204.10)	$ 1,171
2008	$ 154.31	$ 1,440.20	$ 257.18	$ (100.32)	$ 1,751

Chart 2 – AIP Expenses vs A&O, Total

Year	Total A&O+LAE	Total Expense	Expense Deficit
1992	$ 240.43	$ 257.58	$ (17.15)
1993	$ 243.16	$ 258.44	$ (15.28)
1994	$ 282.09	$ 296.55	$ (14.47)
1995	$ 380.52	$ 443.38	$ (62.85)
1996	$ 471.59	$ 531.80	$ (60.22)
1997	$ 441.24	$ 527.57	$ (86.33)
1998	$ 443.76	$ 553.42	$ (109.66)
1999	$ 500.60	$ 615.09	$ (114.49)
2000	$ 552.14	$ 692.79	$ (140.65)
2001	$ 635.87	$ 819.21	$ (183.34)
2002	$ 625.89	$ 826.94	$ (201.05)
2003	$ 733.66	$ 896.85	$ (163.19)
2004	$ 889.42	$ 1,021.51	$ (132.10)
2005	$ 829.25	$ 990.31	$ (161.06)
2006	$ 958.58	$ 1,163.15	$ (204.57)
2007	$ 1,332.63	$ 1,564.82	$ (232.19)
2008	$ 2,012.73	$ 2,128.02	$ (115.29)

Chart 3 - 2008 Comparison of A&O to Agent Commissions by State Group

2008	Group 1	Group 2	Group 3
A&O	20.2%	20.6%	20.8%
Avg. Comm. Rates	**19.3%**	**15.7%**	**14.1%**
Comm % of A&O	95.5%	76.2%	67.8%
Residual to cover other costs	0.9%	4.9%	6.7%

Chart 4 – 2009 Comparison of A&O to Agent Commissions by State Group

2009	Group 1	Group 2	Group 3
A&O	17.1%	18.6%	18.6%
Avg. Comm. Rates	**18.6%**	**15.2%**	**13.2%**
Comm % of A&O	108.8%	81.7%	71.0%
Residual to cover other costs	-1.5%	3.4%	5.4%

Chart 5 - Federal Crop Insurance Program History

Year	No. of Policies Earning Premium	Company Underwriting Gain/(Loss)	Company A&O
1981	11,002	287,763	4,247,674
82	73,767	2,557,520	23,702,671
83	98,889	(2,620,307)	34,479,551
84	202,464	(650,817)	84,549,616
85	279,795	3,349,903	100,759,003
86	308,756	7,991,554	102,627,875
87	352,835	16,001,922	105,591,524
88	386,417	(8,049,873)	137,462,169
89	768,801	28,892,316	262,368,004
90	798,363	51,134,007	268,195,421
91	630,185	41,309,936	234,676,271
92	603,851	21,811,739	240,016,763
93	625,533	(83,326,250)	242,684,632
94	772,516	103,270,641	281,612,706
95	1,230,780	132,302,113	377,482,626
96	1,180,158	247,571,252	468,150,343
97	1,192,831	352,070,977	437,840,045
98	1,241,858	279,208,820	443,261,499
99	1,289,060	271,756,850	500,658,031
00	1,324,176	281,781,555	552,136,965
01	1,298,070	346,371,756	664,403,012
02	1,259,143	(46,678,793)	625,827,785
03	1,241,230	381,403,682	736,046,145
04	1,228,434	690,870,576	889,424,605
05	1,191,141	917,018,786	829,160,230
06	1,154,977	821,688,842	958,338,737
07	1,137,442	1,571,848,934	1,332,473,396
08	1,148,819	1,104,819,028	2,009,408,048
09*est.	1,168,909	2,194,093,980	1,606,358,668

Chart 6 – Projected A&O Payments

	Actual	Projected	Draft 2	No. Policies	2006
1995	$380.52			2034.337	958.5774
1996	$471.59			1615.191	958.5774
1997	$441.24			1319.762	958.5774
1998	443.7626			1242.663	958.5774
1999	500.6013			1288.778	958.5774
2000	552.1353			1323.243	958.5774
2001	635.87			1297.925	958.5774
2002	625.8931			1259.484	958.5774
2003	733.6589			1241.468	958.5774
2004	889.4154			1228.847	958.5774
2005	829.2532			1190.606	958.5774
2006	958.5774			1147.681	958.5774
2007	1332.631			1137.662	958.5774
2008	2012.734			1149.019	958.5774
2009	1618.707			1171.605	958.5774
2010		1515.227		1229.424	958.5774
2011		1530.401	1226.694	1230.391	958.5774
2012		1523.476	1185.3	1231.715	958.5774
2013		1540.769	1150.76	1160.861	958.5774
2014		1578.437	1183.261	1160.689	958.5774
2015		1598.557	1207.261	1160.682	958.5774

Charts 7 and 8 – NASS-Based Loss Ratios

Chart 7 - Iowa		Chart 8 - Texas	
Year	NASS LR	Year	NASS LR
1958	0.07	1958	0.7
1959	0.07	1959	1.18
1960	1.39	1960	0.79
1961	0	1961	0.46
1962	0.02	1962	1.44
1963	0	1963	1.78
1964	0	1964	0.81
1965	0.75	1965	0.48
1966	0	1966	0.46
1967	0.7	1967	2.05
1968	0	1968	0.23
1969	0	1969	1.12
1970	0.91	1970	0.6
1971	0	1971	2.73
1972	0	1972	1.23
1973	0	1973	0.04
1974	4.77	1974	2.78
1975	2.03	1975	0.81
1976	2.91	1976	0.25
1977	3.41	1977	0.07
1978	0	1978	2.56
1979	0	1979	0.08
1980	0.12	1980	1.77
1981	0	1981	0.03
1982	0.1	1982	1.44
1983	4.93	1983	0.85
1984	2.06	1984	0.4
1985	0.06	1985	0.01
1986	0.01	1986	1.59
1987	0.01	1987	0.31
1988	7.4	1988	0.5
1989	1.35	1989	2.57
1990	0.44	1990	0.24
1991	1.86	1991	0.94
1992	0.01	1992	1.06
1993	9.51	1993	0.05
1994	0	1994	0.83

Chart 7 - Iowa		Chart 8 - Texas	
Year	NASS LR	Year	NASS LR
1995	1.93	1995	1.41
1996	0.32	1996	1.51
1997	0.57	1997	0.01
1998	0	1998	1.82
1999	0.04	1999	0.27
2000	0.82	2000	2.37
2001	0.87	2001	1.13
2002	0	2002	1.33
2003	2.19	2003	1.08
2004	0	2004	0
2005	0	2005	0.21
2006	0	2006	3.1
2007	0	2007	0
2008	0.38	2008	0.53
2009	0	2009	2
Average	1	Average	1