



# STANDARD REINSURANCE AGREEMENT FREQUENTLY ASKED QUESTIONS UPDATED FOR FINAL DRAFT - JUNE 10, 2010

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## **1. How did the Risk Management Agency (RMA) determine changes offered in the final draft agreement of the Standard Reinsurance Agreement (SRA)?**

As with the second draft, RMA considered comments and recommendations from participating crop insurance companies and other stakeholders to develop the provisions of the final draft. The final draft agreement 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 final draft agreement, 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 final draft agreement?**

A&O subsidies are payments made to companies, on behalf of producers, to cover the cost of selling and servicing the policy. In recent years, companies have received significant increases in A&O payments, based on increasing commodity prices, while the number of policies sold have actually decreased. Therefore, as with the first and second drafts, the final draft agreement removes the potential for windfall A&O payments based on extreme commodity price spikes.

However, instead of using reference prices to avoid these windfalls, as in the first two draft versions, the final draft agreement allows A&O payments to fluctuate, but removes the potential for extreme windfall profits by establishing an overall maximum total of A&O subsidy expenditures. It also gives companies protection if commodity prices fall. The A&O methodology includes an inflation adjustment factor and accommodates new programs so that the maximum payments will gradually increase over the length of the agreement (See Chart 6).

### **3. Why did RMA decide not to use reference prices to calculate A&O in the final draft agreement?**

As noted by many companies in comments on the draft SRA, price volatility factors have become significant in the determination of premiums for the increasing number of revenue-based policies and, consequently, the A&O subsidy for those policies. Using reference prices alone to stabilize the A&O subsidy accounts for levels of high commodity prices, but ignores changes in price volatility. After further evaluating the impact of price volatility factors on the A&O subsidy calculation, RMA determined that fixing price levels alone through reference prices would not guarantee that total A&O subsidy expenditures would be effectively stabilized.

Further analysis by RMA also indicated that using reference prices for the seven major commodities in the A&O subsidy determination could affect areas of the country differently, depending on the types and mixture of crops in each area. Such differences could lead to undesirable changes in the amount of A&O subsidy available for program delivery in certain areas.

In response to these concerns, RMA decided that its objectives with respect to A&O restructuring could be achieved using an alternative method -- establishing an overall maximum total of A&O subsidy expenditures. A&O expenditures limited on the upside will effectively remove the potential for windfall increases from increases in crop price levels and price volatility. At the same time the new SRA will protect the companies from a significant decline in crop prices. In discussions between RMA and the companies, a strong interest emerged in using this approach as an acceptable alternative to the use of reference prices.

### **4. What changes were made to the agent commission cap in the final draft agreement?**

The second draft SRA included a “soft cap” that limited base agent commissions to 80 percent of the A&O subsidy, but also allowed the companies to share any underwriting gains with agents. This feature remains in the final draft SRA. In addition, a “hard cap” has also been included to assure that all companies can compete on a fair and equitable basis in all states regardless of where their business concentration may exist. Under the hard cap, the sum of agent commissions and profit sharing with agents cannot exceed 100 percent of the A&O subsidy provided to the company for that state.

RMA considered concerns expressed by many companies and others that a soft cap alone would provide an incentive for some companies to only write business in the most profitable states. Companies writing in the most profitable states would attract agents by claiming a potential for more consistent and higher rates of return and, consequently, greater availability of funding to provide for agent profit sharing. Providing a hard cap on profit sharing will limit the potential for companies to engage in such market-disrupting activities. Federal crop insurance is a National Government program and the SRA should ensure that the companies and their agents have the incentives to provide service to all producers.

Both the soft cap and the hard cap in the final draft would operate on the state level. This will give the companies flexibility with regard to profit sharing within the state, but will prevent companies from expending all of their underwriting gains on just a few states in order to expand their book of business in those areas. By placing a limit on the total amount of compensation available to agents within a state, the

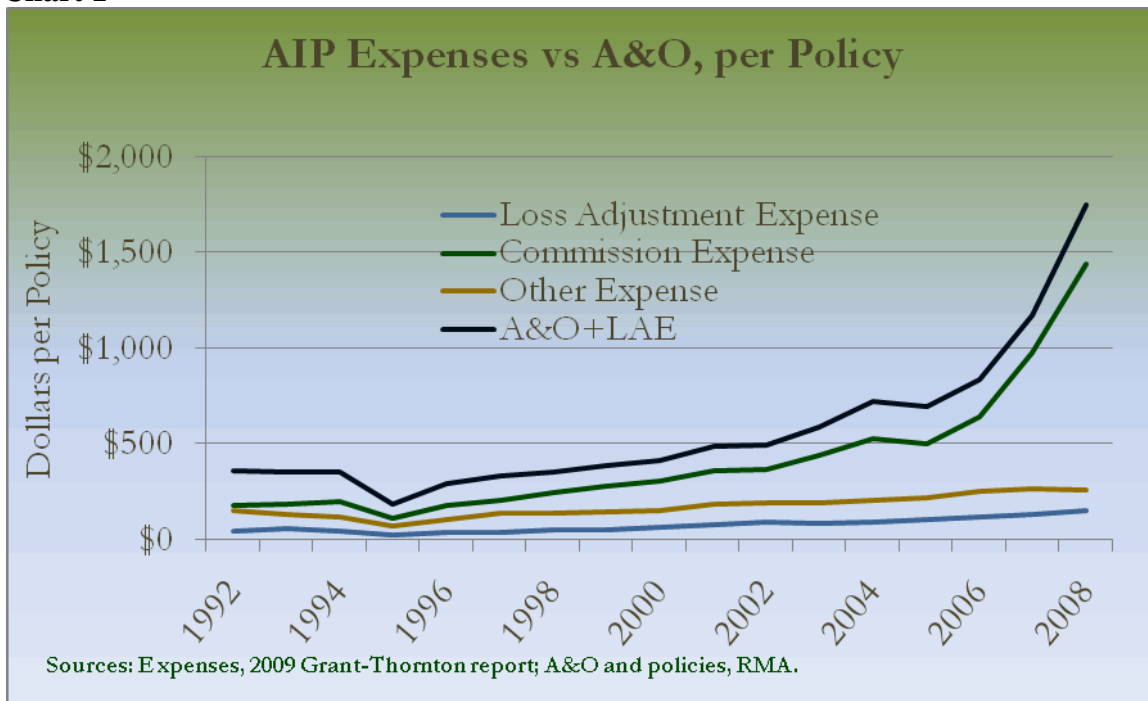
incentive for companies to concentrate on just the most consistently profitable states will be reduced. The hard cap will provide a more level ‘playing field’ for those companies with significant business in the higher risk states, and underserved and less-served states. It will also provide all companies with a greater incentive to compete on the basis of superior policyholder service, rather than bidding up agent commissions.

Even with the hard cap, the expected amount of compensation potentially available to agents will be about \$1.3 billion annually, given the expected A&O subsidy and average expected underwriting gain amounts provided by the final draft. On average, for the 2011 to 2015 life of the SRA, agent commissions will be limited to about \$1.1 billion annually, while profit sharing will be limited to about \$270 million annually. On average, the 100 percent cap allows around one-third of total underwriting gains to be shared with agents, as determined by the companies.

### 5. Why did RMA cap base agent commissions?

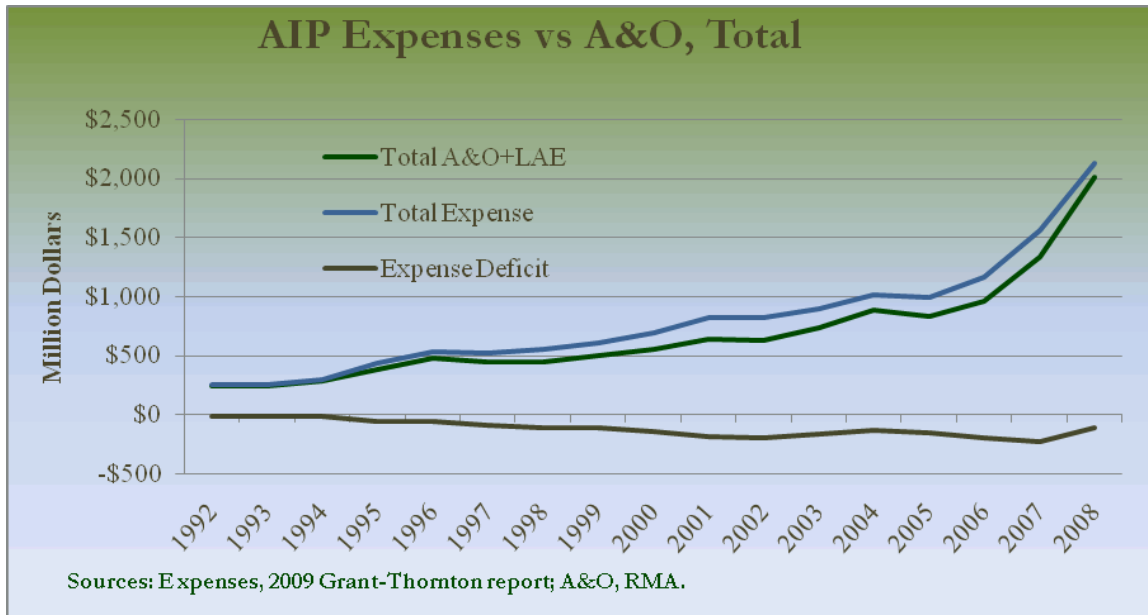
This provision responds to calls from Members of Congress, academia, Government accountability organizations, and the insurance companies themselves to moderate the unsustainable growth in agent commissions. In particular, the US Government Accountability Office (GAO) report (GAO-09-445, “Crop Insurance: 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.

**Chart 1**



Please refer to Table 1 for data supporting Chart 1

**Chart 2**



Please refer to Table 2 for data supporting Chart 2

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.

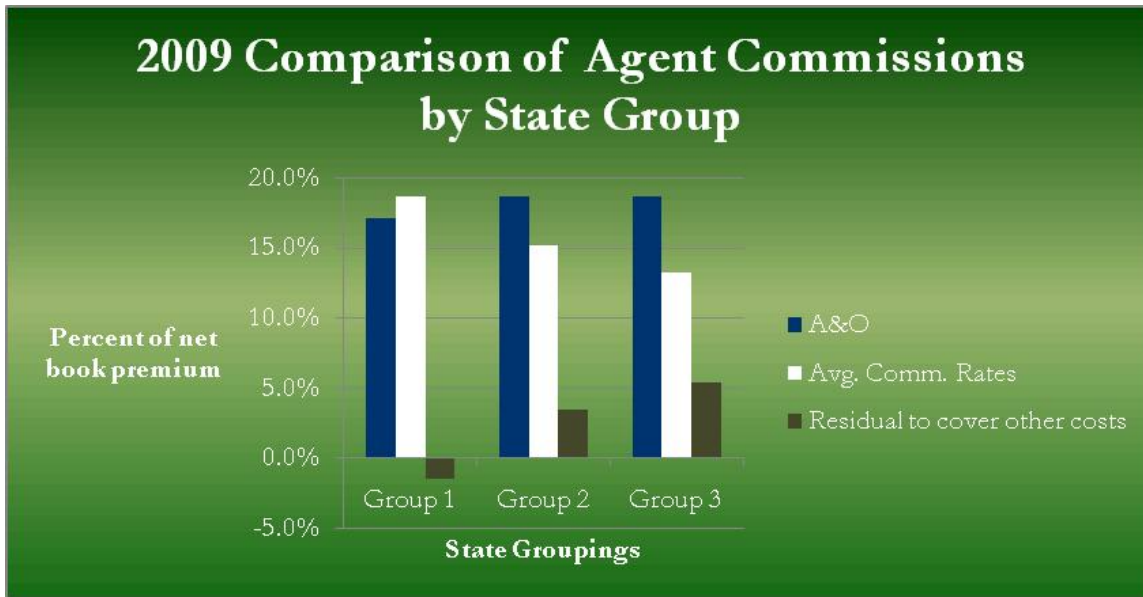
In fact, in 2009, *average* agent commission rates in the Corn Belt (Group 1 States) were 18.6 percent of premium and the A&O paid to the companies was 17.1 percent, meaning the companies paid *108.8 percent* of their A&O subsidy to agents in this area (See Chart 4). By comparison, average commission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

**Chart 3**



Please refer to Table 3 for data supporting Chart 3

**Chart 4**



Please refer to Table 4 for data supporting Chart 4

Additionally, not even half of the A&O reductions from the 2008 Farm Bill were passed on to agents in the form of lower commissions. 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. RMA is committed to preventing this situation from occurring again. The cap on agent commissions will minimize the potential for a company to go bankrupt because it is making unsustainable commitments to its agents.

#### **6. What changes does the final draft agreement make to its risk sharing provisions?**

- Through its risk sharing terms (underwriting gains and losses), the final draft preserves RMA's rebalancing efforts to more effectively reach underserved and less-served producers, commodities, and areas. Many companies generally supported this effort but with modifications adopted as follows: as with the second draft, the states are divided into separate state groups in the Commercial Fund (described in question 18) according to each State's historical underwriting performance. This provision seeks to better balance reinsurance performance geographically and provide companies with a financial incentive to sell and service underserved and less-served areas. Group 1 represents the 5 States with the highest levels of expected return under the current SRA. The other 45 States (Groups 2 and 3) will receive more generous reinsurance terms compared to the current SRA. The

final draft agreement provides reinsurance terms in Group 2 and 3 States with more profit potential and less risk.

- In addition, the Residual Fund is replaced with a return to the Assigned Risk Fund (described in question 19), similar to the current agreement. The Assigned Risk Fund will allow companies to reinsure policies in a highly protected fund at the state level.
- The Net Book Quota Share (described in question 20) will be set at 6.5 percent, with 1.5 percentage points of any underwriting gain to be distributed to those companies 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 so that companies can make long-term plans and investments in these States.

## **7. What are the three state groupings in the final draft agreement?**

The state groups in the final draft are the same as 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.

## **8. How will this negotiation affect farmers and ranchers?**

The terms of the SRA do not affect premium rates. These rates are required by law to be actuarially sound and are based on long-term program performance. They are not negotiable.

However, through the savings achieved by a restructured SRA, USDA will be able to provide a performance based discount or refund. This will provide certain producers in the program with a discount or refund on premium based on performance. For many years, some producers have suggested that they should be rewarded for demonstrating good performance and thus contributing to the overall good financial health of the program. Through this SRA, we are making this possible.

The savings achieved will also be used to increase the number of approved risk management products. Many products, such as the Pasture, Rangeland, and Forage (PRF) program, which benefits ranchers and forage producers, have not been able to expand as quickly as we would like in recent years because of administrative pay-as-you-go rules – the Administration must find an equal decrease in spending in order to pay for an expansion in a program. As a result of the savings, from the SRA, PRF will be able to expand to many additional counties across the country. Together with the good farmer discount, this will mean that many farmers will have more insurance products available to them and have lower costs.

Many farmers and ranchers will not see any change in the 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 new 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 accessible, and equally affordable crop insurance program for farmers. With this new agreement, we expect to have a stronger Federal crop insurance program for the long term that helps producers manage their risk and that serves farmers in every region of the country.

## **9. Does the final draft protect the agriculture budget baseline for the next Farm Bill?**

Throughout the SRA negotiation process, officials from every level at USDA and the Obama Administration have worked to strengthen the farm safety net and protect taxpayers from higher costs in the future. The savings that result from eliminating windfalls in government payments to insurance companies will be used to strengthen programs that directly help farmers and to reduce the national deficit. Specifically, \$2 billion will be allocated to Farm Bill programs and \$4 billion will be allocated to the important task of deficit reduction.

USDA responded to the concerns of many Members of Congress and farm groups that the new SRA would result in a significant reduction in the agriculture budget baseline. USDA plans to target additional funding for important risk management tools and agriculture conservation programs, directly benefitting America's farmers and ranchers. These steps include releasing approved risk management products, such as the expansion of the Pasture, Rangeland, and Forage program and providing a performance based discount or refund, which will reduce the cost of crop insurance for certain producers. USDA will also increase Conservation Reserve Program (CRP) acreage to the maximum authorized level, and invest in new and amended Conservation Reserve Enhancement Program initiatives. In the near future, USDA will release detailed information describing the investments that will be made using savings generated from a restructured SRA.

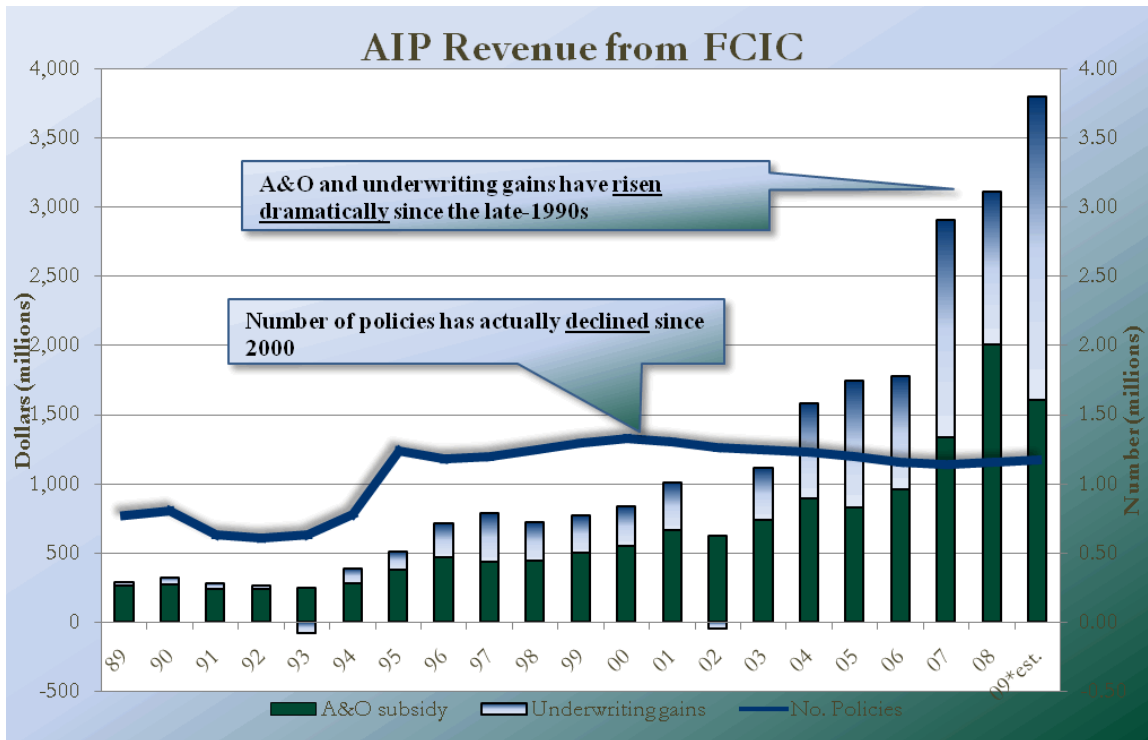
By reducing the national deficit, the Administration has worked to ensure that the new SRA will benefit both farmers and taxpayers. Officials throughout the Administration are committed to bringing a new responsibility for how tax dollars are treated. We are taking the common-sense steps that families and small businesses take with their budgets – to make sure we spend money wisely. This is an important step to get this country's fiscal house in order so we do not pass on a crippling debt to our children and grandchildren.

## **10. 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. Companies, 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 the 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 (See Chart 5). The new 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.

**Chart 5**



Please refer to Table 5 for data supporting Chart 5

### 11. 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, high price volatility factors (price risk), 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. Additionally, the current agreement has no limit on total A&O payments paid out. Thus, as commodity prices have spiked in recent years, so too have A&O payments to companies. Nevertheless, 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. Moreover, 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. Before renegotiating the SRA, A&O payments were projected to remain above \$1.5 billion through 2015 (around \$1,300 per policy) because of expected, continued, higher-than-normal, 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. This means that for every \$1.00 the program earned in premium, it was paying out \$1.40 in indemnities. The structure established then, which is still 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.

## **12. 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 analysis, when updated for 2009, indicates that over the last 21 years the “reasonable rate of return” for crop insurance companies averaged 12.7 percent, while the companies actually received an average rate of return of 17.0 percent. For 2009, the return for the industry was 26.4 percent, the second highest return in the past 21 years and well above the reasonable rate of return for 2009, 10.7 percent.

### **13. 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 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. This analysis has now been updated to include 2009.

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.

### **14. Will the companies’ A&O subsidy be “cut” under the new SRA?**

The A&O subsidy will continue to operate as it currently does; however, it will be limited to avoid excess A&O payments to the industry. This approach is designed to prevent windfalls as seen in recent years, which were primarily due to the spike in commodity prices. This approach effectively protects the program from the impact of high commodity prices and price volatility on the amount of A&O provided to companies. The maximum A&O amount is projected to start around \$1.3 billion in 2011 and increase with inflation to \$1.367 billion in 2015. This is almost 40 percent higher than the \$935 million that the industry received in A&O payments in 2006, the last year before the price spikes. It is also about 35 percent less than the A&O payment in 2008, the year at the height of the price spike (See Chart 6).

RMA is confident that these changes provide the companies with the resources needed to deliver the program. In addition, because the A&O subsidy will be less vulnerable to extreme 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.

### **15. Will the new agreement provide enough A&O to cover delivery costs?**

Yes. RMA drafted this agreement in such a way that it will provide the companies with a reasonable amount to deliver the program. The expected average A&O payment will be about \$1140 per policy over the next 5 years. Thus, companies will receive payments significantly higher than the \$835 average payment per policy in 2006 (See Chart 6).

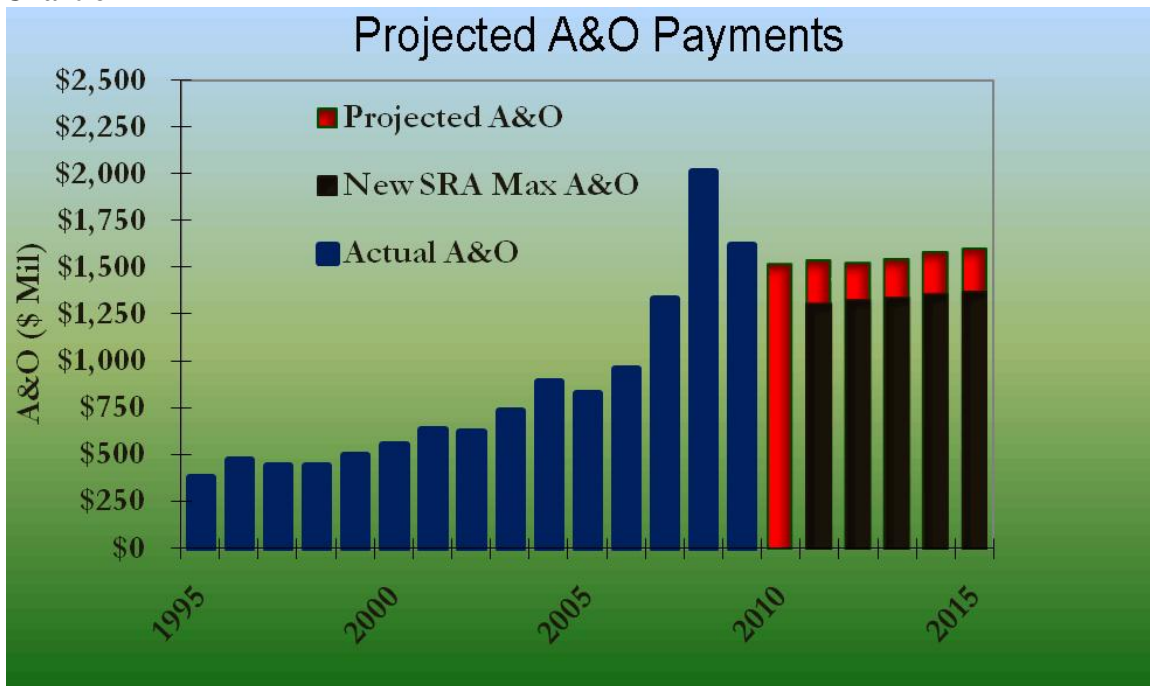
RMA does recognize that regulation from the Government since the last renegotiation has added some costs to company operations; however, these additional costs are not commensurate to the increase in the overall A&O subsidy per policy and are largely offset by the implementation of increasingly automated processes – such as quality control. The new 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 \$1,140 per policy, well above the \$400 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 new agreement helps the companies do this by providing a cap on commissions.

While some companies previously suggested that reducing their A&O payments would make them suffer a net loss in the program, the examples provided to us assumed that expenditures for commissions remain at very high levels. Companies that would have continued 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. That is why we have included an agent commission cap to ensure that high agent commissions do not lead to the insolvency of a company due to a lack of cost containment.

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.

**Chart 6**



Please refer to Table 6 for data supporting Chart 6

**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 new SRA, by providing relatively stable A&O payments and providing a 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 new SRA?**

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 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 in which companies can place policies 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 insurance plans.

Therefore, the current structure establishes seven distinct funds in each of the 50 states, 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 final draft agreement simplifies these terms by reducing the total number of potential funds from seven per state to two per state – the Commercial Fund and the Assigned Risk Fund.

## **18. What is the Commercial Fund?**

The Commercial Fund provides the companies with greater opportunity for profit, but also the greater opportunity for loss. Typically the companies place their safest or best performing policies in this fund to allow for more gain, but they are also cognizant of more loss potential in this fund than in the Assigned Risk Fund. The new agreement includes reforms to the Commercial Fund in order to level the playing field across rural America. As mentioned in question 6, the new agreement differentiates the gain and loss sharing structure according to state groupings based on 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 new agreement, the states are divided into three groups (listed in question 7). 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 new agreement, the Commercial Fund is structured so that the Government assumes a greater share of extreme gains or losses in the most profitable states, while ensuring that companies will still have profit potential that will provide a reasonable rate of return nationwide.

## **19. What is the Assigned Risk Fund?**

The current SRA includes an Assigned Risk Fund, in which companies can reinsure risk on a state-by-state basis. Companies tend to place their riskiest policies in each state in the Assigned Risk Fund because it is the most protective fund. In the second draft SRA the Assigned Risk Fund had been replaced by a nationwide Residual Fund per company. However, due to the companies' concerns that they would no longer have state "stop-loss", or protective reinsurance against state-level disasters, the final draft agreement will return to a state-by-state Assigned Risk Fund. Through the Assigned Risk Fund, companies can ensure that one bad event in a particular state does not cause unintended underwriting consequences in other states.

The Assigned Risk Fund also responds to calls by oversight bodies to make sure that companies have enough profit potential and share enough risk in these policies that they have the proper incentives to service the policies properly and work claims appropriately. In the final draft agreement companies have more risk and more profit potential to achieve this goal. At the same time, the Assigned Risk Fund maintains fairly protective terms so that companies can still honor their promise to service all areas of the United States, even the riskier areas.

## **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 final draft agreement establishes the Net Book Quota Share at 6.5 percent. However, 1.5 percent of any underwriting gain 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. Unlike the second draft, the final draft does not include a limit on this "giveback" amount. The percentage given back to the companies in the final draft decreased from 2.5 percent to 1.5 percent, making the limit unnecessary.

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

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

Currently, A&O subsidies provided to the companies can fluctuate dramatically with changes in commodity prices and other factors such that steep declines in commodity prices could leave companies with fewer resources to deliver the program. The final draft agreement protects the industry from extreme price fluctuations. The companies also currently purchase commercial reinsurance to protect themselves from catastrophic losses. Under the reinsurance terms of the new SRA, the Government will now take on more of the catastrophic risk. This will provide more protection in bad years and reduce dependence on commercial reinsurance.

With the new proposed structure, volatility of earnings will be reduced, giving the companies a more predictable and level earnings rate. RMA stress test analyses indicate that companies will fare better in bad years under the terms of the new agreement, especially in the Group 2 and Group 3 States.

This added stability will reduce the likelihood that companies will be financially jeopardized after a bad year. With financially stable private companies, America's farmers and ranchers 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 final draft agreement ensures that companies can provide adequate compensation for crop insurance professionals in rural America that is neither excessive nor insufficient. The levels of projected funding are well above that of the mid-2000s, which provided many good jobs within rural America supporting the crop insurance program. Funding provided under the new agreement will also be more stable and sustainable for the long term. These changes will result in more financial stability for agents, loss adjusters, company employees, and others in rural America that are affiliated with the crop insurance industry.

In addition, the final draft agreement will provide new financial incentives for companies to continue reaching out to areas in which there are currently a limited number of companies and agents selling policies, thus providing farmers and ranchers with better access to these risk management tools.

## **23. What changes does the new agreement 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 encouraged by the Office of the Inspector General and 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 process consists of verifying the information pertaining to the actual production history (APH) to determine whether the coverage on the policy 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, the company was required to verify a full 3 years of APH information for APH reviews. The final draft agreement modifies and simplifies the APH claim review process for producers and companies. To comply with \$100,000 claim review requirements, the company will verify the producer's data for the most recent year. If this information is accurate and the company can confirm that the producer has his or her prior years' records, then the APH verification requirement will be satisfied. If there are problems with the current year, then the company will need to review prior years. Thus, the APH review process will be simplified, while continuing to be an effective tool to ensure program integrity.

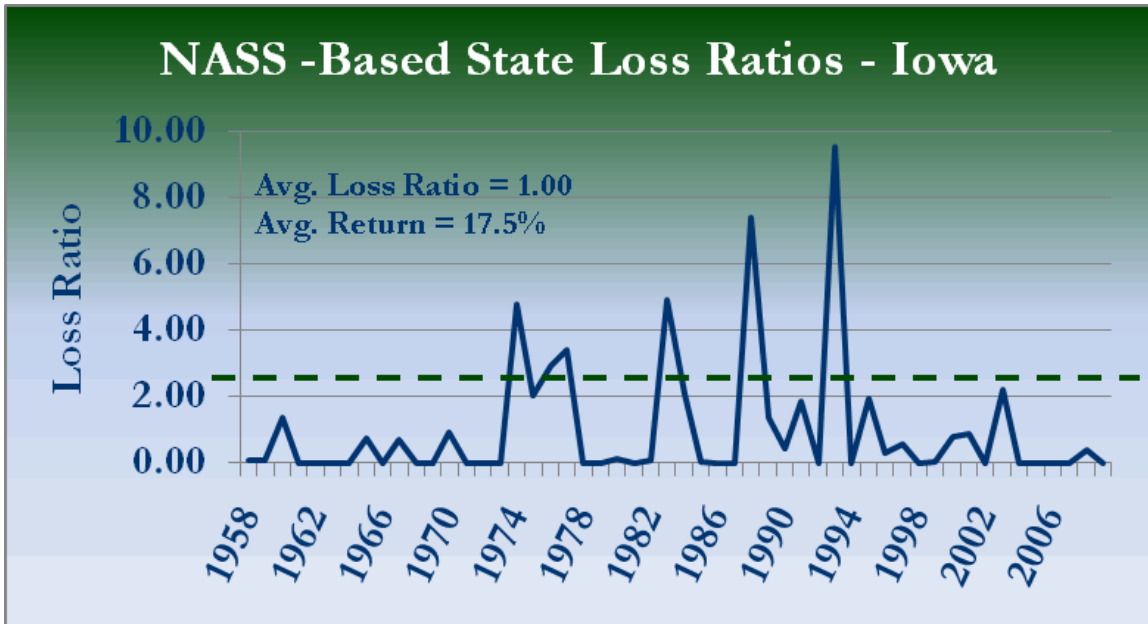
## **24. Can't rebalancing be accomplished through the revision of premium rates?**

The difference in underwriting gains across states is due to their differing risk profiles. The two graphs below (Charts 7 and 8) show the loss ratios for Iowa (a high-return State) and Texas (a low-return State) based on historical state-level National Agriculture Statistics Service (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 period is 1.00. In other words, the premium rate in both States is actuarially sound.

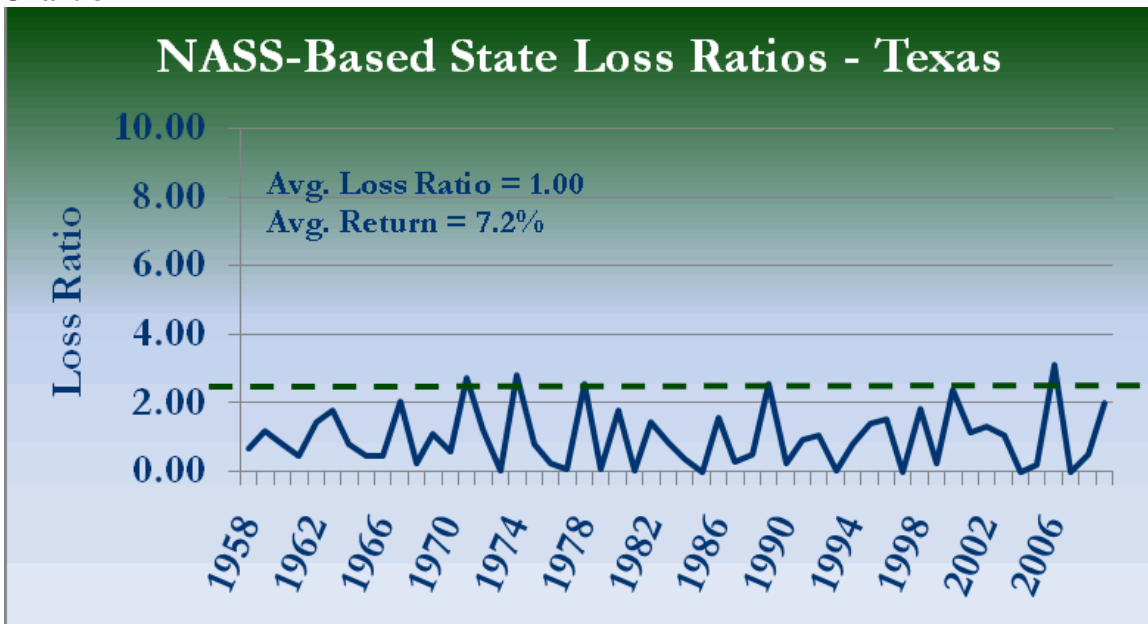
Charts 7 and 8 show the different risk profiles of Iowa and Texas. Significant losses in Iowa tend to be infrequent, but are extremely severe when they occur. Loss ratios are generally below 1.00 for years at a time, punctuated by catastrophic losses. In contrast, significant losses occur with much greater 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 final draft agreement 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 “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 Charts 7 and 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 changes to the reinsurance terms are designed 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.

## **26. How will the agreement affect the rest of rural America?**

The final draft agreement 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. There is expanded 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. There is rebalancing of 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.

Lastly, there is a provision to give back a portion of the Net Book Quota Share to those insurance providers that sell and service policies in 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.

**Table 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

**Table 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)

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

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

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

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

**Table 5 - Federal Crop Insurance Program History**

<b>Year</b>	<b>No. of Policies Earning Premium</b>	<b>Company Underwriting Gain/(Loss)</b>	<b>Company A&amp;O</b>
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

Table 6 – Projected A&O Payments

	<b>Actual</b>	<b>Projected- (from USDA 2009 Baseline)</b>	<b>New SRA Max A&amp;O</b>
<b>1995</b>	<b>\$380.52</b>		
<b>1996</b>	<b>\$471.59</b>		
<b>1997</b>	<b>\$441.24</b>		
<b>1998</b>	<b>443.7626</b>		
<b>1999</b>	<b>500.6013</b>		
<b>2000</b>	<b>552.1353</b>		
<b>2001</b>	<b>635.87</b>		
<b>2002</b>	<b>625.8931</b>		
<b>2003</b>	<b>733.6589</b>		
<b>2004</b>	<b>889.4154</b>		
<b>2005</b>	<b>829.2532</b>		
<b>2006</b>	<b>958.5774</b>		
<b>2007</b>	<b>1332.631</b>		
<b>2008</b>	<b>2012.734</b>		
<b>2009</b>	<b>1618.707</b>		
<b>2010</b>		<b>1515.227</b>	
<b>2011</b>		<b>1530.401</b>	<b>1300</b>
<b>2012</b>		<b>1523.476</b>	<b>1319</b>
<b>2013</b>		<b>1540.769</b>	<b>1335</b>
<b>2014</b>		<b>1578.437</b>	<b>1350</b>
<b>2015</b>		<b>1598.557</b>	<b>1367</b>

<b>Tables 7 and 8 – NASS-Based Loss Ratios</b>			
<b>Chart 7 - Iowa</b>		<b>Chart 8 - Texas</b>	
<b>Year</b>	<b>NASS LR</b>	<b>Year</b>	<b>NASS LR</b>
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