



STANDARD REINSURANCE AGREEMENT (SRA) FREQUENTLY ASKED QUESTIONS

1. What are the Risk Management Agency's objectives for this negotiation?

RMA has six objectives in renegotiation of the agreement:

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

RMA believes that the maintenance of the farm safety net is critical to ensuring a safe, affordable, and abundant food supply in this country and that the continuing strength and viability of the Federal crop insurance program is integral to that purpose. With the restructured provisions of the first draft of the SRA for 2011, we preserve the program's strengths while complying with the 2008 Farm Bill's directives to effectively address the significant rise in Government expenditures resulting from the structure of the current SRA. RMA has drafted an agreement that incorporates many of the companies' suggestions and producers' needs to create a win-win-win-win scenario for producers, companies, consumers, and taxpayers.

2. How will this negotiation affect farmers and ranchers?

No farmer or rancher will see increased 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 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.

Another goal of the SRA negotiations is to protect producers from higher costs. Producers will not see a rise in premium with this new agreement. Any changes to the premium subsidy percentages require Congressional action.

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 in place a stronger Federal crop insurance program that helps producers better manage their risk and that serves farmers in every region of the country.

3. 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 approximately 85 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 (CHART 1). 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.

4. 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 payment of companies' Administrative and Operating (A&O) subsidies. A&O subsidies are payments made to companies on behalf of the policyholder to cover the cost of selling and servicing the policy. In other words, Congress did not finish reform in the 2008 Farm Bill; it expected RMA to further reform the 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 2009, while the number of total policies decreased from 1.3 million in 2000 to 1.2 million in 2009. In today's challenging fiscal environment, these developments are unsustainable for hard-working American taxpayers.

5. 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 improvements to the program that the companies have benefitted from.

Under the existing agreement, A&O payment is based solely on premium costs, which are directly influenced by underlying commodity prices. As commodity prices rise and decline, premiums change, causing proportional changes in the value of A&O subsidy provided by the Federal Government. A&O subsidies have increased dramatically in recent years due to spikes in commodity prices, even though the cost of servicing the policies has not.

As recently as 2006, A&O payments were well below \$1 billion annually and the average payment per policy in 2006 was about \$835. 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 the high commodity prices.

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 to the extent that insurance premiums received either exceed or are less than claims paid. The current structure was established in an era when loss ratios were relatively high—averaging above 1.4. (The loss ratio is claim payments divided by premiums.) The structure established then 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 about 0.85. 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 over 3 years.

6. What is a “reasonable rate of return” for crop insurance companies?

RMA used sound economic and insurance principles during its pre-decisional analysis, as directed in the 2008 Farm Bill, in determining reasonable levels for Federal crop insurance program expenditures to companies. RMA considered several reports and studies, including a Government Accountability 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 met RMA’s requirements for being independent, 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 our partner crop insurance companies should be expected to earn, including a normal profit, 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 have 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 30 percent, well in excess of the estimate for a reasonable rate of return of about 12 percent.

7. What time frame 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 more fully consider this possibility, 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.

8. Will the companies A&O subsidy be “cut” under the new draft SRA?

In the new draft SRA, RMA has restructured the A&O subsidy to effectively neutralize the impact of high commodity prices and year to year volatility for major commodities on the A&O subsidy. In doing so, however, it wanted to ensure that an adequate A&O subsidy was provided to companies so that the delivery of Federal crop insurance to producers was not jeopardized. Therefore, RMA ensured that the amount of A&O subsidy per policy was at least equal to the amount available in 2006—a year in which the A&O subsidy was ample for program delivery and before the meteoric rise in commodity prices. Under the new SRA, the A&O subsidy for 2009 would have been \$992 per policy, a 9 percent increase above the A&O subsidy that was paid out per policy in 2006. It is important to note that this estimated increase per policy also incorporates the “Farm Bill cuts.”

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.

9. 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 new draft SRA, the A&O will be about \$940 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 effectively deliver the program.

RMA does recognize that regulation from the government since the last renegotiation has added some costs to company operations; however, these additional costs are minimal compared to the overall A&O subsidy per policy and are largely offset by the implementation of increasingly automated processes – such as the 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.

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.

10. 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 locked in and will not change with for the duration of the agreement. 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 change for the duration of the agreement, 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.

11. 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 for 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 new draft SRA has one Commercial Fund in each of the 50 states and one nationwide Residual Fund, for a total of 51 potential funds.

12. 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 to be shared across all companies. The concept is roughly similar to high risk motorist insurance pools that are established in many states. The Residual Fund will provide stability to the program by pooling risk and spreading it more evenly geographically and among companies. 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 or with one company, but will be more widely distributed and shared. The Residual Fund will also increase each company's incentive to protect program integrity because they will now share risk with other companies.

The Residual Fund will protect individual companies against unusually bad years in particular areas and will even out reinsurance performance.

13. 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 modifies the Commercial Fund by differentiating the gain and loss sharing structure according to state groupings. The states are divided into four 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.

Another change in the Commercial Fund is that the government would assume a greater share of extreme gains or losses in a state. This feature would add stability to the program by providing companies with greater protection in the event of a significant and widespread weather event.

14. What are the four groupings in the new Commercial Fund?

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

“State Group 2” includes California.

“State Group 3” includes Kentucky, Ohio, Oregon, Tennessee, Washington, and Wisconsin.

“State Group 4” includes Alaska, Alabama, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Kansas, Louisiana, Maine, Massachusetts, Maryland, Michigan, Missouri, Mississippi, Montana, North Carolina, North Dakota, New Hampshire, New Jersey, New Mexico, Nevada, New York, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Virginia, Vermont, West Virginia, and Wyoming.

15. What is Net Book Quota Share?

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 new draft SRA increases the Net Book Quota Share to 10 percent, which means the government would retain 10 percent of a company’s gains or take 10 percent of a company’s losses. If there is an underwriting gain (and only if there is a gain) a portion of the increase (the increase from 5 to 10 percent) would be distributed back to those companies who are effective in reaching underserved areas. The criteria for receiving this extra “profit share” from the government would be laid out clearly by RMA far in advance of each reinsurance year, so that companies may be able to try to meet these criteria of servicing underserved areas. The criteria could change each year to meet new goals in expanding the program, but would always be directed to help underserved producers, areas, and crops.

16. 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 two 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 two bad years in a row.

This added stability will reduce the likelihood that companies will drop out of the program after a bad year and will help ensure that they make a reasonable and stable return. With financially stable private companies, America’s producers can be assured of full crop insurance opportunities and uninterrupted service.

17. 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 foster job creation opportunities in the crop insurance industry and will provide more financial stability to farmers and ranchers by providing them with better access to these risk management tools.

18. 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. 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.

19. 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 four groups in the Commercial Fund and improving the reinsurance terms for underserved states.

The adoption of the new Residual Fund will also reduce the current disincentive for companies to service high risk

areas, because it pools this risk across the industry. To the extent that underserved areas are high risk areas, the Residual Fund in the draft SRA improves the incentive to provide service to these areas. Also, the draft SRA contains a provision to “profit share” a portion of the Net Book Quota Share with those insurance providers that incur additional costs and make a special effort to reach underserved or underserved areas.

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

CHART 1

