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Report to Congressional Requesters

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CROP INSURANCE

FCIC Needs to Improve Its Oversight of Reinsured Companies

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Resources, Community, and
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The Honorable Ed Jones
Chairman, Subcommittee on Conservation,
Credit and Rural Development
Committee on Agriculture
House of Representatives

The Honorable Glenn English
Chairman, Subcommittee on Government
Information, Justice, and Agriculture
Committee on Government Operations
House of Representatives

In response to your requests and subsequent agreements with your offices, we examined certain oversight activities of the Department of Agriculture's Federal Crop Insurance Corporation (FCIC) over private companies that insure farmers against crop losses caused by natural disasters. Proper loss adjustment (settling claims for crop damages covered under the insurance policy) is an important federal concern because FCIC, as reinsurer of the private companies, pays for most of the losses experienced on all policies sold. According to FCIC officials, in crop year 1987,[1] FCIC paid about $300 million in losses through the reinsured companies. Since 1980 FCIC has paid losses of almost $2 billion on policies written and adjusted by reinsured companies.

Last year we identified problems with the loss adjustment activities of reinsured companies. Our findings were communicated in testimony and a subsequent report to the Chairman of the Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture.[2] Among other things, we found that FCIC provided only minimal oversight of the loss adjustment activities of reinsured companies and that, as a result, FCIC had overpaid millions of dollars in loss claims.

We reported that 95 percent of the 134 claims we examined were incorrectly adjusted and over 30 percent of all loss payments we reviewed resulted in nearly $3 million in overpayments. As a result of these findings, we made several recommendations to the Secretary of Agriculture

[1]Crop year denotes the year in which a crop was harvested.

[2]Assistant Comptroller General J. Dexter Peach testified on April 29, 1987 (GAO/T-RCED-87-18); the report was entitled Crop Insurance: Overpayment of Claims by Private Companies Costs the Government Millions (GAO/RCED-88-7, Nov. 20, 1987).

aimed at requiring the Manager of FCIC to increase oversight and control over the loss adjustment activities of the reinsured companies. The recommendations included making improvements in (1) monitoring and evaluating the activities of the companies, (2) training adjusters and supervising quality reviews, and (3) establishing internal controls over reinsured claims prior to payments to reduce errors.

As agreed, this report presents (1) our analysis of FCIC's system for monitoring the loss adjustment activities of reinsured companies with particular emphasis on the adequacy of individual company reviews that FCIC conducts as part of this monitoring system and (2) the results of follow-up on other recommendations contained in the 1987 report. A more detailed description, including some relevant background information and our objectives, scope, and methodology, is included in appendixes I to III.

Results in Brief

Although FCIC has taken actions to improve the oversight of the loss adjustment activities of reinsured companies, more needs to be done. A principal recommendation in our 1987 report was that FCIC needed to establish a comprehensive and systematic monitoring program of reinsured companies to ensure that they were following FCIC's standards. In response to the 1987 draft report, FCIC stated that it was well on its way to establishing such a program and that, since late 1986, it had been performing systematic reviews of reinsured companies' operations. However, these reviews do not always provide a basis for drawing conclusions about the overall quality and acceptability of a company's loss adjustment process because (1) the scope of the reviews was limited—large portions of a company's operations had no chance of being examined, (2) the reviews did not use statistically valid techniques for sampling claims, and (3) FCIC has no criteria for evaluating the results of its reviews to determine whether a company's performance is acceptable or unacceptable. The ability to validly conclude that a company is performing acceptably or unacceptably is essential to an effective oversight system. This ability is particularly significant since FCIC's current agreement with the reinsured companies stipulates that if a company's performance is unacceptable, FCIC can take over its loss adjustment function.

FCIC actions concerning other recommendations contained in our earlier report have been mixed. FCIC has implemented some of our recommendations and is in the process of implementing others. For example, FCIC is collecting overpayments referred to it in 1987. It also is developing a systematic method for collecting overpayments. FCIC has not taken action on all our recommendations, however. For example, FCIC disagreed that it should require reinsured companies to submit documentation in support of each payment request prior to payment, as we had recommended. The status of each of our earlier recommendations is detailed in appendix III.

FCIC Reviews Are Limited in Scope

Most reinsured companies sell and service insurance in many different locations across the nation, and the quality of a company's loss adjustment can vary from location to location. While FCIC is considering ways to expand the scope of its reviews, past reviews have examined a limited portion of a company's operations. We examined the scope of reviews covering the loss adjustment activities of 27 companies in crop year 1986, the last completed crop year at the time of our review. Most of these reviews were completed in calendar year 1987. We found that reviews of 20 companies covered locations in less than 10 percent of the counties in which a company did business. For example, one review examined 3 of the 1,487 counties covered by a company. In another case, FCIC reviewed a company twice in 1 year; the combined coverage of the reviews was 11 of the 1,195 counties in which the company did business.

FCIC officials recognize that the scope of many past reviews had been limited because of their desire to cover as many companies as possible. They are currently considering ways to increase the scope of reviews. For example, FCIC plans to cover all of a reinsured company's field offices within a 14-month period. This type of approach, combined with other methodological design improvements that we are recommending, would help FCIC to draw broader conclusions about a company as a whole.

FCIC Reviews Are Not Statistically Valid

An important aspect of FCIC's loss adjustment reviews involves sampling a company's loss adjustment claims to determine if they were conducted properly. However, in many of the FCIC reviews that we examined, the sample could not be used to support reliable conclusions about the quality of a company's overall adjustment practices in those specific company locations reviewed because of (1) the manner in which the FCIC selected its sample of claims and (2) the limited size of the sample.

First, FCIC guidelines for sampling claims do not ensure that selection is random. The sample may not be representative of all claims within the company or company locations being reviewed. Second, the number of claims sampled in the reviews we examined was often inadequate for developing reliable conclusions about a company's loss adjustment performance. In this regard, for the 29 FCIC reviews that we examined, we found that, even if the claims had been randomly selected, many reviews may not have sampled enough claims to reach reliable conclusions about the company's loss adjustment performance for the specific locations reviewed. For example, in one review the best estimate of the company's error rate (percent of claims with errors) that could be supported by the sample examined ranged from as little as 6 percent to as high as 45 percent.

Performance Criteria Are Needed

FCIC has not established basic criteria for determining acceptable loss adjustment performance by a reinsured company. For example, FCIC has not developed criteria for using the error rates found as a result of its loss adjustment reviews to determine whether a company is performing at an acceptable level of proficiency. Without such criteria, the results of FCIC reviews cannot be properly interpreted, and determining the circumstances under which it would take disciplinary actions against a company becomes rather arbitrary. Thus, any attempts at taking disciplinary actions against a company on the basis of FCIC reviews could be questioned.

Conclusions and Recommendations

Over the past few years, federal crop insurance was intended to be the nation's primary disaster assistance program, with the hope that increasing numbers of farmers would look to crop insurance in evaluating their individual risk management alternatives. At the same time, reinsured companies are capturing an increasingly larger share of crop insurance sales—from 3 percent in 1981 to about 83 percent in 1987. These conditions combine to underscore the urgency for FCIC management to move expeditiously and effectively to get on top of the loss adjustment activities of reinsured companies. As the importance of crop insurance grows, the Department of Agriculture, the Congress, and the public will need assurance that only valid and accurate payments are made. Too frequent occurrences of invalid and inaccurate crop insurance claims can only serve to undermine the viability and effectiveness of the program. As a result, we continue to believe that FCIC should fully implement all the recommendations made in our 1987 report. Further, on the basis of this review, we believe additional recommendations are merited.

We therefore recommend that, to improve the effectiveness of FCIC's oversight of the loss adjustment activities of reinsured companies and to provide a better basis for judging the overall performance of individual companies, the Secretary of Agriculture should require the Manager of FCIC to:

- Emphasize the use of statistically valid random sampling techniques and appropriate sample sizes, where it is cost beneficial, in selecting claims for review.
- Develop criteria to use in evaluating the results of compliance reviews and for determining the acceptability of a company's loss adjustment performance. For example, criteria need to be established for evaluating the acceptability of error rates found in sampled claims. The criteria should explicitly state when FCIC will suspend a company's operations and the circumstances under which FCIC will assume a company's loss adjustment function.

FCIC Comments and Our Evaluation

We discussed our findings, conclusions, and recommendations with the FCIC Manager, Deputy Manager, and Assistant Manager of the Compliance Office. They generally agreed with our report. However, they said the tone could have been more positive to highlight the improvements FCIC, particularly the Compliance Office, has made in oversight of loss adjustment. We have therefore noted, as appropriate, improvements that FCIC is developing.

While FCIC officials recognize the benefits of using statistically valid random sampling techniques and appropriate sample sizes, they are concerned about the additional resources that may be necessary to implement such sampling plans. They intend to examine their sampling methodology further to devise a strategy that would efficiently use FCIC resources and make the most of statistical sampling. In addition, according to the officials, FCIC will use random selection in future reviews and document the random sampling in its reports. Regarding the need for criteria to determine acceptable levels of company performance, FCIC has established a task force to develop the criteria and the Manager intends to establish and incorporate them in the 1990 agreement with reinsured companies.

FCIC has made progress in its oversight of the reinsured companies, particularly with the establishment of the Compliance Office in 1986. We have added language on pages 13 and 15, recognizing that the Compliance Office has made improvements. FCIC appears to be headed in the right direction by planning to establish random sampling of company claims during compliance reviews and criteria for determining whether a company is performing acceptably. However, since these plans are still in development, it is too early to evaluate them.

We conducted our review from January to June 1988 using generally accepted government auditing standards. The information contained in this report was obtained primarily through contacts with FCIC headquarters and field staff and from documents obtained from FCIC management. We also interviewed representatives of the reinsured companies. As requested, we did not obtain written agency comments on this report. However, we discussed its contents with the Manager and other top officials of FCIC and incorporated their comments where appropriate.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 2 days after the date of this letter. At that time we will send copies to the Secretary of Agriculture; the Manager, FCIC; the Director, Office of Management and Budget; and other interested parties. Major contributors to this report are listed in appendix IV.

J. Dexter Peach

J. Dexter Peach
Assistant Comptroller General

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Abbreviations

ASCS	Agricultural Stabilization and Conservation Service
CHIAA	Crop Hail Insurance Actuarial Association
FCIC	Federal Crop Insurance Corporation
GAO	General Accounting Office
USDA	U.S. Department of Agriculture

Background and Objectives, Scope, and Methodology

American farmers face many uncontrollable natural hazards that can prevent planting or destroy crops. Crop insurance provides protection to agricultural producers from losses caused by unavoidable disasters such as insects, disease, fire, hail, drought, floods, freezing, and wind. The U.S. Department of Agriculture's (USDA) Federal Crop Insurance Corporation (FCIC), a government-owned corporation, was created in 1938 to promote the national welfare by improving the economic stability of agriculture through a sound program of federal crop insurance.

Background

Before 1980 the crop insurance program operated on a limited basis, covering certain crops and selected counties. For example, in the late 1970s the program covered 27 crops in about 1,700 of the country's 3,100 counties. The Federal Crop Insurance Act of 1980 (Public Law 96-365) called for an expanded crop insurance program by authorizing a subsidized, all-risk, all-crop, nationwide program. Since passage of the 1980 act to 1987, FCIC has expanded its insurance coverage to include about 40 crops in about 3,000 counties across the United States. It was intended to be the nation's primary agricultural disaster assistance program, with the hope that it would become increasingly relied upon by farmers as a risk management tool.

The 1980 act provides an insurance program for farmers to protect their crops against essentially all unavoidable risks. The act requires that the program operate on an actuarially sound basis with premium income sufficient to cover losses. The act further requires that FCIC establish, as expeditiously as possible, a reasonable reserve against unforeseen losses. Also, the 1980 act requires that FCIC shall, among other things,

- use the private sector, to the maximum extent possible, to sell and service crop insurance policies and
- provide a program of reinsurance (whereby part or all of the risk is transferred from the original insurer—a private company—to FCIC), to the maximum extent practicable, to begin not later than the 1982 crop year.

Prior to the 1980 act, FCIC sold and serviced crop insurance policies using its own employees, employees of USDA's Agricultural Stabilization and Conservation Service (ASCS),[1] and a small number of independent agents. At that time FCIC employees adjusted loss claims. (Adjusting

[1] ASCS administers commodity and related land use programs designed for voluntary production adjustment; resource protection; and price, market, and farm income stabilization.

losses is the assessment and determination of the amount and cause of the loss in crop yield.) In implementing the expanded insurance program under the 1980 act, FCIC believed that heavy reliance on the private sector would be necessary in order to reach a high level of farmer participation in the program. Moreover, the shift to the private sector was viewed as being in accordance with the congressional intent of the act. The 1980 act states that FCIC should ". . . to the maximum extent possible . . . contract with private insurance companies . . . and encourage the sale of federal crop insurance through licensed private insurance agents and brokers . . . ."

Accordingly, FCIC developed an Agency Sales and Service Agreement and a Standard Reinsurance Agreement. Under the former agreement an insurance company or agency (commonly referred to as a master marketer) agrees to sell and service FCIC insurance policies. FCIC compensates the master marketers for their services on a commission basis—currently about 20 percent of the approximately $61 million in crop year 1987 premiums, according to FCIC officials. FCIC maintains responsibility for adjusting losses on the policies sold by master marketers. Also, FCIC incurs all losses on policies sold by master marketers and realizes all gains.

Under the Standard Reinsurance Agreement, private insurance companies sell, service, and adjust the losses on policies they sell under their own names. The reinsured companies are also compensated for administrative, operating, and claims adjustment expenses—currently 34 percent of the companies' total premiums—plus a reimbursement for a portion of any state premium taxes paid. FCIC also provides the companies with reinsurance coverage as protection against most of the risk that could result from losses incurred by the companies and shares in any gains or losses with the companies. Under the 1987 agreement, reinsured companies were responsible for a maximum underwriting loss of about 15 percent of premiums on their business. FCIC was responsible for paying losses on a claim above 15 percent. FCIC officials said that in crop year 1987, reinsured companies had gains of about $16 million.

In 1987 about 85 percent of all crop insurance sales were made by reinsured companies. Concurrent with the expansion of the program and the move to rely on private companies to sell and service crop insurance, FCIC has been experiencing financial difficulties. From 1981 through 1987 insurance claims (indemnities) totaled about $3.8 billion compared with premium income of about $2.7 billion, or a net loss of almost $1.1

billion. FCIC has paid out an average of $1.40 in claims for each $1 of premium income earned.

Events Leading to Review

In 1986, the Chairman of the Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture, asked us to review the loss adjustment practices of reinsured companies. As a result of this review, we found problems with the quality of the work being done by the reinsured companies as well as with FCIC's oversight and control over the activities of the companies. In subsequent congressional hearings and a report, we described the problems we found.[2]

Specifically, we found that loss adjustments made by reinsured companies resulted in millions of dollars in government overpayments. In reviewing $9.4 million in claims, we found that about $3 million, or 31 percent, was overpaid. Further, 95 percent of the 134 claims we examined were incorrectly adjusted. We reported that, in our opinion, the problems we identified were so consistent and frequent that they were indicative of a nationwide problem.

In addition to the problems with the companies' loss adjustment activities, we also found that FCIC management needed to be improved. Specifically, we found FCIC had exercised little oversight of the activities of reinsured companies until 1986—about 5 years after the program began. Moreover, FCIC neither verified loss information that the companies submitted nor accurately screened claims for obvious errors prior to payment.

As a result of our findings, we made several recommendations to the Secretary of Agriculture to improve the effectiveness of FCIC and reinsured company operations. Our recommendations dealt with FCIC's attaining increased and more effective oversight and control of reinsured company operations and upgrading the operational requirements that FCIC placed on companies.

FCIC responded to our findings by citing a number of things being done or planned that, in its opinion, would go far toward helping overcome the problems we identified. FCIC officials said that they would implement

[2]Testimony by Assistant Comptroller General J. Dexter Peach, April 1987, before the House Subcommittee on Conservation, Credit, and Rural Development (GAO/T-RCED-87-18); and Crop Insurance: Overpayment of Claims by Private Companies Costs the Government Millions (GAO/RCED-88-7, Nov. 20, 1987).

most of the recommendations in our 1987 report. In discussing FCIC initiatives to improve the loss adjustment operations of reinsured companies and in responding to our recommendations, officials said they are relying on the Compliance Office to accomplish the needed oversight and control that was lacking in earlier years. The Compliance Office is an organizational unit within FCIC, established in 1986, that acts as the agency's oversight and enforcement arm. One of its principal responsibilities is to ensure that reinsured companies adjust losses properly. Since its inception, the Compliance Office has reviewed portions of most reinsured companies.

Objectives, Scope, and Methodology

We made this review as a result of a joint request from Congressman Ed Jones, Chairman, Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture; and Congressman Glenn English, Chairman, Subcommittee on Government, Information, Justice, and Agriculture, House Committee on Government Operations. Reacting to the problems identified in our testimony and subsequent report, the Chairmen were concerned that FCIC take effective actions to correct the identified problems. As a result, they asked us to evaluate the effectiveness of FCIC reviews of loss adjustment activities by private companies and to assess the adequacy of FCIC's responses to recommendations contained in our 1987 report on loss adjustment. Although we reviewed the implementation of all our recommendations, we concentrated heavily on our recommendation that FCIC, through its Compliance Office, systematically monitor the loss adjustment activities of reinsured companies. We emphasized this because the Compliance Office is the linchpin of FCIC's oversight efforts. In following up on this recommendation, we:

- Reviewed FCIC's Compliance Handbook, which outlines procedures for conducting various types of compliance reviews—including loss adjustment reviews—of individual reinsured companies.
- Accompanied a compliance reviewer on a loss adjustment review of one company.
- Reviewed 29 reports containing the results of all routine crop year 1986 loss adjustment reviews that FCIC's Compliance Office had conducted from its creation in August 1986 though June 1988. These reviews were the most recently completed set of reviews for a crop year at the time of our review. Most were completed in calendar year 1987, and FCIC considered them indicative of a comprehensive and systematic evaluation program, as we had recommended. The Deputy Manager, FCIC, said these reviews were completed when the office was new, and its chief goals were to respond to complaints and quickly examine every company to

determine where the biggest problems occurred. The Assistant Manager, Compliance, said the crop year 1987 reviews, which were not completed in all cases, had some changes but were generally conducted in the same manner. Our review included examining the scope of the compliance reviews, the recommendations contained in the reviews, and the length of time necessary to report the results of the reviews to the companies.

- Analyzed FCIC guidelines used when selecting a sample of claims to examine during a loss adjustment review. Also, we examined the reliability of estimates that could be made based on these samples, assuming that these samples were randomly selected. This part of our analysis incorporated the use of generally accepted statistical theory.

To evaluate FCIC's response to the remaining recommendations contained in our 1987 report, we documented the status of FCIC's actions as of June 1988 through a review of FCIC policies, procedures, and practices. In the event that FCIC had not fully implemented the recommendation, we obtained an explanation for why it had not.

We conducted our work at FCIC headquarters in Washington, D.C., and at its main field office in Kansas City, Missouri. In addition to reviewing documents at these locations, we interviewed FCIC's Manager as well as officials at the Corporation's Compliance Office, Actuarial Services and Actuarial Statistics Divisions, Comptroller Division, and Reinsured Division. We also spoke with officials from the Crop Hail Insurance Actuarial Association (CHIAA)—an organization representing the crop insurance industry—because they were largely involved in implementing one of our recommendations.

We conducted our review between January and June 1988 using generally accepted government auditing standards. Although we did not obtain written agency comments, we discussed this report with the Manager, FCIC, and incorporated his comments where appropriate.

FCIC Cannot Reliably Assess the Overall Quality of Loss Adjustment Activities

FCIC's Compliance Office is primarily responsible for implementing a principal recommendation in our 1987 report. In that report we recommended that FCIC establish a comprehensive monitoring and evaluation program to ensure that reinsured companies comply with FCIC standards, particularly those pertaining to loss adjustment. In responding to our 1987 draft report, FCIC noted that it was well on its way to implementing this recommendation and, since late 1986, had been performing systematic reviews of reinsured companies operations through its Compliance Office. While FCIC has made progress by initiating a review process, our current analysis indicates that these reviews do not always provide a basis for making reliable conclusions about the overall quality and, thus, acceptability of a company's loss adjustment process because (1) the scope of the reviews is limited, (2) the sample selection methodology is not statistically valid, and (3) no criteria exist to evaluate the results of the reviews and determine whether companies are performing acceptably. The capability to conclude whether or not a company is performing acceptably is essential to an effective oversight system. Without this capability, FCIC cannot effectively assume the loss adjustment function of reinsured companies that do not meet FCIC standards.

How the Compliance Office Does Its Work

FCIC created the Compliance Office in 1986 chiefly to monitor whether reinsured companies comply with the Standard Reinsurance Agreement. The agreement describes the terms under which (1) the private companies sell, service, and adjust the losses on policies and (2) FCIC provides reinsurance coverage to the private companies. To implement its responsibilities the Compliance Office conducts various types of on-site reviews that focus on different aspects of a company's operations. For example, some reviews are designed to examine how well a company implements its sales responsibilities while others concentrate on a company's loss adjustment process. In addition to conducting these and other types of scheduled company reviews, the Compliance Office also is responsible for responding to specially requested reviews of company operations. Such requests may come from farmers, USDA officials, or companies themselves.

Loss adjustment reviews have been one of the most frequently conducted types of compliance review. As of June 1988 the Compliance Office had examined this function in most of the 41 reinsured companies. Also, FCIC considers loss adjustment reviews the most comprehensive of any of the reviews that are performed because they can cover anything from sales activities to claims adjustment. Generally they involve

- examining a company's claims procedures to verify compliance with FCIC-approved policies, procedures, and regulations, such as timeliness of payments and accurate completion of claim forms by the company;
- accompanying a reinsured company's loss adjuster on inspections of damaged cropland as part of the claims settlement process; and
- reviewing a sample of claims adjusted by the company to determine whether or not loss adjustment was performed properly.

Scope of Compliance Office Reviews Is Limited

Most reinsured companies sell and service insurance in many different locations across the nation. Compliance reviews generally examine a company's operations within certain geographic locations. Because the quality of loss adjustment can vary by location, the results of such reviews are generally applicable only to those locations examined. The scope of many Compliance Office loss adjustment reviews that we examined was extremely limited—only a small geographical portion of the company's loss adjustment operations was subject to review. As a result, using the reviews to support conclusions about the overall quality of the company's loss adjustment function is difficult. FCIC is currently considering ways to increase the scope of its reviews.

To determine the number of company locations included in a review, we examined the scope of the 29 loss adjustment reviews completed for crop year 1986 claims. We found that FCIC reviewed 27 companies; 2 companies were reviewed twice and the other 25 companies were reviewed once.

Among 20 of the 27 companies reviewed, FCIC reviewed less than 10 percent of the counties in which a company did business. Further, among 24 of the 27 companies reviewed, FCIC covered less than 20 percent of the counties in which a company did business. Table II.1 summarizes the geographic coverage of the reviews that we examined.[1]

[1]For purposes of this analysis, we considered a county to be "reviewed" if the compliance review covered at least one claim adjusted by the company in that county. This assumption overestimates the scope of Compliance Office reviews because companies usually adjust more than one claim in a county.

Table II.1: Scope of Selected Compliance Reviews

Review	Number of counties FCIC reviewed	Total counties covered by company	Percent of counties covered
A	17	669	2.54
B	4	833	0.48
C&D	11	1,195	.92[a]
E	7	332	2.11
F	7	133	5.26
G	7	780	.90
H	3	1,487	0.20
I	10	59	16.95
J	12	121	9.92
K	4	132	3.03
L	4	176	2.27
M	10	44	22.73
N	12	47	25.53
O	3	61	4.92
P	12	83	14.46
Q	9	114	7.89
R	5	101	4.95
S	8	229	3.49
T	4	184	2.17
U	5	151	3.31
V	8	109	7.34
W	9	29	31.03
X&Y	15	1,368	1.10[a]
Z	8	603	1.33
AA	14	210	6.66
AB	10	89	11.24
AC	8	56	14.29

[a]Two reviews of the same company were combined here.

As table II.1 indicates, many FCIC reviews covered only a small portion of companies' operations. FCIC officials recognize that the scope of many past reviews has been limited. They noted that this was, in part, a result of their initial desire to use limited resources of the newly formed Compliance Office to establish a "presence" in the industry. In June 1988 they began to take steps to increase the scope of their reviews. For example, under proposed standards, a minimum of three to five states and a minimum of seven counties would be covered in a review of each field office of a reinsured company. Further, FCIC plans to cover all of a reinsured company's field offices within a 14-month period. Expanding the scope of compliance reviews is a step in the right direction and, when combined with other methodological design improvements that we are recommending, would help FCIC to draw broader conclusions about the company as a whole.

Compliance Reviews Are Not Statistically Valid

One important aspect of loss adjustment reviews involves evaluating a sample of claims adjusted by the reinsured company to determine whether the claims have been adjusted properly. As noted in the previous section, compliance reviews do not always cover all geographic locations where a company operates. Therefore, conclusions stemming from the sample of claims examined during a loss adjustment review are limited to the company's operations within the locations visited. However, for most of the reviews that we examined, it was not even possible to reach statistically valid and reliable conclusions about the quality of loss adjustment operations within the locations reviewed because of problems concerning (1) the manner in which the sample of claims was selected and (2) the size of the sample.

Sample Not Selected Randomly

To use sampling techniques to support conclusions about the accuracy of claims adjustments performed within a segment of a company or a company as a whole, the claims included in the sample must be representative of all claims from which the sample was selected. To ensure that bias is not introduced into the sample, generally accepted statistical theory requires the use of random selection. FCIC guidelines for sampling claims, however, do not ensure that selection is random. Thus, the sample may not be representative of all claims in the location being reviewed.

Procedures for selecting claims during a loss adjustment review are contained in FCIC's Compliance Handbook. These procedures are not in accordance with generally accepted random selection techniques. For example, the handbook suggests that a reviewer examining a company with 1,500 claims should complete 30 reviews, starting with the 50th claim and selecting every 50th claim after it until 30 are selected. The handbook does not require the selection of a random starting point. As a result, this procedure violates the definition of random sampling because all claims do not have a chance of being selected. For example, claims 1 through 49, 51 through 99, etc., would never be selected. Because the sample is not random, there is no assurance that the claims examined provide a representative view of the segment of a company's loss adjustment activities that is being reviewed. Further, the handbook states that under certain circumstances the sample should be expanded, but it does not provide any guidance on how the additional claims should be selected. Consequently, there is no assurance that the additional claims will be selected randomly. The Manager, FCIC, said that FCIC plans to assign a random starting point on future reviews. Additionally, FCIC plans to document how the claims were randomly selected in the compliance reports.

Sample Size Often Inadequate

The reliability of conclusions about the quality of a company's loss adjustment practices depends not only on how the sample was selected but also on the size of the sample. The larger the random sample of claims reviewed, the more likely it is that the sample represents characteristics of all the claims from which it was selected. Using standard statistical techniques, we analyzed the adequacy of sample sizes in 29 Compliance Office reviews of 27 companies. We found that, even if claims had been randomly selected, many of the reviews may not have sampled enough claims to reach reliable conclusions about a company's performance at the locations reviewed. For example, if an error rate higher than 15 percent were considered unacceptable, FCIC could not make reliable conclusions about the adequacy of 20 of the 27 companies examined for loss adjustment activities.[2] If an error rate higher than 10 percent were considered unacceptable, FCIC could not make reliable conclusions about the adequacy of 15 of the 27 companies reviewed. The following examples illustrate how the sample size may be inadequate.

Example 1. In one review, FCIC examined a company that did business in 669 counties of 13 states and processed almost 4,000 claims in crop year 1986. FCIC sampled 25 of 297 claims at 17 counties within 2 states.[3] Three of the sampled claims had errors amounting to $2,466 in overpayments.

In this case, the sample cannot be used to draw reliable conclusions about the company's overall error rate because not all of the claims had a chance to be selected—only those at the locations reviewed. Further, even if random sampling had been used for the locations that were reviewed, the estimated error rate among the 297 claims could have been as low as 3 percent or as high as 28 percent because of the small number selected for review.

[2] FCIC has not established criteria that define acceptable and unacceptable company performance. See page 22.

[3] The number of claims at selected locations is estimated. See table II.2, footnote a.

Example 2. During another review, FCIC examined a company that did business in 780 counties of 33 states and processed almost 7,000 claims in crop year 1986. FCIC sampled 16 claims out of 89 claims at 7 counties within 1 state.[4] Two of the sampled claims had errors amounting to about $3,272 in overpayments.

Similar to the previous example, the sample cannot be used to draw statistically valid conclusions about the company's overall error rate because not all of the claims had a chance to be selected—only those in the seven counties reviewed. Further, even if random sampling had been used for the locations that were reviewed, the estimated error rate among the 89 claims could have been as low as 2 percent or as high as 33 percent.

In addition to demonstrating how insufficient sample sizes can reduce the reliability of estimating error rates, the two examples demonstrate the difficulty facing FCIC in attempting to determine whether the companies are performing at acceptable levels of competency. In each of the examples above, the sample size would have to be increased in order to reduce the range of the estimated error rate for the portion of the company that was reviewed. Table II.2 summarizes information on the precision of error rate estimates given current sample sizes for all 29 reviews that FCIC has conducted.

[4]Ibid.

Table II.2: Company Error Rates for Locations Reviewed by FCIC
(Crop Year 1986)

Total company claims nationwide	Estimated total claims in locations reviewed[a]	Number of errors FCIC found on claims reviewed	Estimated error rates (percent)[b]
3,967	297	3 of 25	3 to 28
6,134	17	2 of 8	12 to 53
9,534	60[c]	9 of 18[c]	38 to 75
1,595	25	1 of 10	4 to 36
418	21	3 of 9	14 to 62
6,991	89	2 of 16	2 to 33
7,686	45	4 of 12	13 to 58
406	77	3 of 15	6 to 43
313	65	3 of 14	6 to 45
711	25	0 to 10	0 to 24
1,086	5	4 of 4	80 to 100
265	45	2 of 12	4 to 42
178	137	0 of 19	0 to 14
108	37	4 of 11	14 to 62
128	77	3 of 15	6 to 43
986	53	1 of 13	2 to 30
1,213	21	4 of 9	19 to 71
3,552	53	0 of 13	0 to 19
1,016	21	2 of 9	10 to 52
541	13	2 of 7	15 to 62
87	137	2 of 19	1 to 28
80	121	6 of 18	17 to 55
9,274	242[c]	9 of 36[c]	14 to 39
2,545	751	11 of 33	20 to 49
610	37	6 of 11	30 to 78
119	45	0 of 12	0 to 20
405	77	4 of 15	10 to 49

[a]FCIC reviews did not document the "total claims in locations reviewed." We therefore assumed that FCIC had chosen sample size in accordance with guidance contained in its Compliance Handbook. Where a range of claims was shown for a sample size, we chose the smallest number in the range. This allowed us to approximate the total number of claims from which the sample was drawn.

[b]These figures represent the low and high estimate of what the company's overall error rate (percent of claims with errors) is for the locations reviewed. The estimates are based on a 90-percent confidence interval and assume that a random sample was drawn.

[c]Two companies each had two separate samples of claims reviewed. The total claims in each of the locations reviewed was chosen from the Compliance Handbook, as in note a. The estimated total claims in locations reviewed, the number of errors found, and the number of claims reviewed in a company's two locations were combined, and one set of error rates was calculated for each company.

We could not determine how many claims FCIC would have to randomly sample to develop reliable conclusions about a company's performance, in part because FCIC has not established criteria defining a maximum error rate that would be considered acceptable performance. If FCIC does establish such criteria, there may be additional costs of randomly sampling an adequate number of claims. For example, staff or travel budgets may increase. However, the added costs may be outweighed by the benefits of the review results, such as the ability to develop conclusions about the loss adjustment activities of a broad portion of a company.

If FCIC finds it is not cost beneficial to randomly sample an adequate number of claims, it should consider developing a procedure that would produce statistically valid conclusions about some portion of a company's claims that FCIC designates as important. For example, FCIC might randomly sample an adequate number of all claims that exceed a certain dollar amount.

The Manager, FCIC, said that he recognizes the benefits of using an appropriate sample size, but he is concerned about the additional resources that may be necessary to implement such sampling plans. He said FCIC plans to examine its sampling methodology further to devise a strategy that would efficiently use FCIC resources and make the most of statistical sampling.

FCIC Needs Criteria for Determining Acceptable Levels of Performance

FCIC has no criteria for determining what is acceptable performance by a reinsured company and what is not for loss adjustment. In our 1987 report we recommended that FCIC establish guidelines for determining what administrative actions to take and when to take them against reinsured companies that do not follow FCIC's standards or that continue to adjust claims improperly. Because FCIC has no criteria for interpreting the error rates found in its loss adjustment reviews, it is not in a position to conclude whether a company is performing its loss adjustment function within acceptable standards.

The need for criteria for determining acceptable levels of performance is important in view of FCIC's responsibility to take actions against a company found to be performing poorly. For example, FCIC can (1) suspend a company from all activities in the program, (2) deny renewal of the annual agreement with a reinsured company, or (3) take over loss adjustment activities of a company. In regard to the latter, the current agreement with the reinsured companies states that FCIC can assume the loss adjustment functions for companies not performing adequately.

FCIC, however, has not yet developed criteria for determining the circumstances under which it would assume a company's loss adjustment function. FCIC has established a committee to examine this matter, and it intends to have the new standards in the 1990 agreement with the reinsured companies. Under the current circumstances any disciplinary action by FCIC would be rather arbitrary. The current review methodology that FCIC uses complicates this matter even further since FCIC is unable to draw reliable conclusions about the accuracy of a company's loss adjustment procedures.

Conclusions

Our 1987 report showed that loss adjustment by reinsured companies received minimal oversight by FCIC and resulted in overpayment of millions of federal dollars. Although FCIC has improved some aspects of program oversight and control, it still lacks assurance that reinsured companies are performing loss adjustment in accordance with FCIC standards.

To improve program oversight and control, our 1987 report recommended that FCIC's Compliance Office implement a comprehensive monitoring and evaluation program for reviewing the loss adjustment activities of reinsured companies. The Compliance Office has now reviewed operations of most of the reinsured companies. However, the reviews do not provide FCIC with a reliable basis for determining whether or not a company is performing at an acceptable level. As a result, the value of the reviews as an oversight mechanism is minimal.

FCIC is attempting to improve the effectiveness and utility of compliance reviews by expanding the coverage of its reviews. While this is a step in the right direction, we believe that FCIC should also address limitations in two other areas. First, FCIC needs to revise its claims sampling methodology to make the sample results statistically defendable, if it is cost beneficial. These revisions should emphasize the use of random sampling and the selection of a sufficient number of claims to support reliable conclusions about the quality of a company's loss adjustment process. If FCIC finds it is not cost beneficial to randomly sample an adequate number of claims, it should consider developing a procedure that would produce statistically valid conclusions about some portion of a company's claims that FCIC designates as important. For example, FCIC might randomly sample an adequate number of all claims that exceed a certain dollar amount.

Second, FCIC needs to develop criteria to evaluate the acceptability of a company's loss adjustment performance. This effort should include developing criteria for evaluating the acceptability of error rates found in the sample of claims that are reviewed during routine FCIC reviews.

Recommendations to the Secretary of Agriculture

To improve the effectiveness of FCIC's oversight of the loss adjustment activities of reinsured companies and to provide a better basis for judging the overall performance of individual companies, the Secretary of Agriculture should require the Manager of FCIC to:

- Emphasize the use of statistically valid random sampling techniques and appropriate sample sizes, where it is cost beneficial, in selecting claims for review.
- Develop criteria to use in evaluating the results of compliance reviews and for determining the acceptability of a company's loss adjustment performance. For example, criteria need to be established for evaluating the acceptability of error rates found in sampled claims. The criteria should explicitly state when FCIC will suspend a company's operations and the circumstances under which FCIC will assume a company's loss adjustment function.

FCIC Comments and Our Evaluation

We discussed our findings, conclusions and recommendations with the FCIC Manager, Deputy Manager, and Assistant Manager of the Compliance Office. They generally agreed with our report. However, they said the tone could have been more positive to highlight the improvements FCIC, particularly the Compliance Office, has made in oversight of loss adjustment. We have added language, as appropriate, to recognize improvements FCIC has made and is considering making.

While FCIC officials recognize the benefits of using statistically valid random sampling techniques and appropriate sample sizes, they are concerned about the additional resources that may be necessary to implement such sampling plans. They intend to examine their sampling methodology further to devise a strategy that would efficiently use FCIC resources and make the most of statistical sampling. In addition, the FCIC officials said they will use random selection in future reviews and it will be documented in their reports. Regarding the need for criteria to determine acceptable levels of company performance, FCIC has established a task force to develop the criteria and the Manager intends to establish and incorporate the standards in the 1990 agreement with reinsured companies.

FCIC has made progress in its oversight of the reinsured companies, particularly with the establishment of the Compliance Office in 1986. We have added language on pages 13 and 15 recognizing that FCIC has made improvements. FCIC appears to be headed in the right direction by planning to establish random sampling of company claims during compliance reviews and criteria for determining whether a company is performing acceptably. However, since these plans are still in development, it is too early to evaluate them.

Mixed FCIC Response to Other GAO Recommendations for Loss Adjustment Improvements

In addition to our recommendation to FCIC about more systematic review of reinsured companies, our November 1987 report made a number of other recommendations aimed at improving FCIC's management and control over the loss adjustment program. FCIC responses to these recommendations have been mixed. It has partially implemented some of our recommendations, but in other cases it has been slow to act or has disagreed. We continue to believe that our recommendations should be fully implemented. The following sections present a status report on FCIC's actions in response to each of the report's recommendations.

Pattern Reinsured Programs After FCIC Program

We recommended that FCIC establish guidelines for improving the quality of loss adjustment activities for reinsured companies. This recommendation included FCIC's requiring that reinsured companies pattern their loss adjustment programs—including loss adjuster training and supervisory quality control reviews—after the more comprehensive and rigorous programs used by FCIC for claims it adjusts on policies sold by master marketers. Our report noted that the more rigorous FCIC loss adjustment training and quality control programs were part of the reason for a significantly lower number of errors found on master marketer claims than on reinsured claims.

FCIC has issued guidelines to improve reinsured company loss adjusters' training and certification. However, the requirements for FCIC contract adjusters who adjust master marketer claims are still more stringent than the guidelines for reinsured company loss adjusters. For example:

- FCIC adjusters for master marketer claims must score 70 percent or higher on a loss adjustment examination to become certified, but FCIC does not require a minimum examination score to certify reinsured company adjusters.
- FCIC adjusters for master marketer claims must adjust four consecutive claims on two different crops (a total of eight) without any major procedural errors. Adjusters can lose their certification if they make two or more major errors consecutively, and without certification they cannot continue to adjust claims without close supervision. To regain certification, the FCIC adjuster must again go through on-the-job training and accurately work four claims. FCIC has no similar requirement for reinsured company adjusters.
- If an FCIC quality control reviewer finds errors in the work of an FCIC adjuster for master marketer claims, the adjuster's wages may be reduced. FCIC does not require that reinsured companies establish wage reductions for errors found in the work of reinsured adjusters.

We believe that until the requirements for reinsured company loss adjusters are equal to those of FCIC's loss adjusters, there will continue to be disparities in the quality of loss adjustment among reinsured companies and FCIC.

Require Documentation Prior to Payment

In light of the scope and depth of the loss adjustment problems we identified in 1987, we recommended that reinsured companies submit documentation to FCIC in support of each payment request at the time the request for payment is made to help ensure that payments by FCIC are accurate and justified. We noted that rather than verifying the information supporting all payment requests, FCIC should verify the information submitted using a statistical sampling approach. We recommended that this process be used until FCIC has fully implemented a comprehensive and systematic monitoring and evaluation program for reviewing the loss adjustment activities of reinsured companies.

FCIC disagreed with this recommendation. FCIC said its other internal controls, such as computerized edits and compliance reviews, will enable FCIC to determine the performance of each company and to identify those companies that do not measure up to FCIC's standards. On the basis of weaknesses noted earlier in this report, we continue to believe that, until FCIC's oversight of reinsured companies' loss adjustment process has improved as recommended in this report, FCIC should require documentation from the reinsured companies.

Computer Screening for Claims Errors

We recommended that, before claims are paid, FCIC establish internal controls, such as computerized audits or screening of reinsured company claims, to ensure that claims do not contain obvious errors. These controls would be similar to the controls FCIC now has on master marketer claims. In making this recommendation we noted that such edits could help ensure, among other things, that payments are made for eligible crops and that the numerical calculations of claims are correct. Further, we noted that such edits could have identified $17.9 million in questionable payments that FCIC made for claims based on drought as a cause of loss for crops grown on irrigated land. Unlike edits of master marketer claims, which are conducted by FCIC, edits of reinsured claims are conducted by the Crop Hail Insurance Actuarial Association, the statistical information-gathering arm of the reinsured companies.

FCIC has begun to implement the recommendation to screen claims for errors. In a January 1988 summary of actions taken in response to our recommendation, FCIC said (1) its edits of master marketer claims data and CHIAA's edits of reinsured company claims data were very similar and (2) FCIC routinely subjects the CHIAA computer tapes to a computerized edit to confirm the accuracy of CHIAA edits. However, FCIC and CHIAA officials told us later that CHIAA edits were not similar to master marketer edits because CHIAA did not require that all discrepancies identified by the edits be resolved before FCIC paid the claims. FCIC expects to correct this problem by requiring reinsured companies to resolve all such discrepancies prior to payment. In regard to confirming the accuracy of CHIAA edits, we found that FCIC has begun to examine CHIAA data, but errors found on crop year 1987 claims had not been resolved during our review.

Systematically Collect Overpayments

Because FCIC had been slow to recover overpayments in the past, we recommended that FCIC establish a systematic process for determining whether identified overpaid claims have been repaid to FCIC with interest where appropriate. FCIC is in the process of implementing this recommendation. The agency is automating its system to provide information on the status of overpayments, recoveries, and followup actions. During our review, the system was not completed, so we could not gauge its performance.

Status of Repayment of Overpaid Claims

We recommended that FCIC require repayment by reinsured companies of about $3 million in overpaid claims we found during our 1987 review of claims adjusted by reinsured companies. Assisted by FCIC staff certified to adjust losses on FCIC crop insurance claims, we had reviewed 134 claims adjusted by reinsured companies for crop years 1984 and 1985 and found 127 claims, or 95 percent, were adjusted incorrectly. Of the $9.4 million in claims reviewed, the net overpayment rate was 31 percent—almost $3 million.

FCIC has collected some of the overpayments and is in the process of collecting more. In October 1987, GAO provided case summaries on each claim that the joint GAO/FCIC team had identified as an overpayment so that the Compliance Office and FCIC management would have the facts necessary to require the return of overpayments. The Compliance Office has reviewed the case summaries and additional supporting documents, visited reinsured companies, and examined their loss adjustment documents. On the basis of this work, the Assistant Manager, Compliance Office, said FCIC is issuing letters calling for the return of identified overpayments. As of August 1988, FCIC had reviewed about 60 percent of the

134 claims and withheld about $0.5 million due to one company to offset its overpaid claims. Also, FCIC sent six companies letters seeking the return of about $410,000 in overpaid claims.

Questionable Payments for Drought Loss

We previously recommended that FCIC determine the extent to which it erroneously paid $17.9 million for losses based on drought on irrigated land. As noted above, we conducted a computerized check of all payment files between 1984 and 1986 and found $17.9 million was paid for claims based on drought on irrigated land. However, according to FCIC procedures, drought is not an insurable cause of loss on irrigated land. The claims may have had computer coding errors or, more seriously, may have been erroneously paid. We brought this to the attention of FCIC in November 1986 so that management could follow up on the problem and take corrective action.

FCIC has not determined the extent that overpayments were made. In a January 1988 response to our recommendation, FCIC said this issue was not necessarily, or even likely, a matter of erroneously paid claims. Later, FCIC officials said there may be some erroneous payments, and they were conducting a review to find any erroneous payments. However, as of June 1988 FCIC officials had not completed a review of the payment files, and they did not know when they would be completed.

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