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CROP INSURANCE

Opportunities Exist to Reduce Government Costs for Private-Sector Delivery

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Mr. Chairman and Members of the Committee:

We are pleased to have this opportunity to discuss the adequacy of the administrative expense reimbursement paid by the U.S. Department of Agriculture's (USDA) Federal Crop Insurance Corporation (FCIC) to participating insurance companies for selling and servicing crop insurance and the comparative cost to the government of delivering catastrophic crop insurance through USDA and the private sector. We also will address alternative means to reimburse companies' administrative expenses for delivering crop insurance. Our testimony today is based on our report, which was mandated by the 1994 crop insurance reform act. This report is being issued today.[1]

In summary, for the 1994 and 1995 period we reviewed, we found that the administrative expense reimbursement rate of 31 percent of premiums paid to insurance companies resulted in reimbursements that were $81 million more than the companies' expenses for selling and servicing crop insurance. The reimbursement is calculated as a percentage of the premiums paid to the companies, regardless of the expenses incurred by the companies. For the 2-year period, companies reported expenses that were less than the reimbursements paid to them by FCIC. Furthermore, we found that some of these reported expenses did not appear to be reasonably associated with the sale and service of federal crop insurance and accordingly should not be considered in determining an appropriate future reimbursement rate for administrative expenses. Among these expenses were those associated with acquiring competitors' businesses, profit-sharing bonuses, and lobbying. In addition, we found other expenses that appeared excessive for reimbursement through a taxpayer-supported program. These expenses suggest an opportunity to further reduce future reimbursement rates. These expenses included agents' commissions that exceeded the industry average, unnecessary travel-related expenses, and questionable entertainment activities.

Finally, a variety of factors that have emerged since the period covered by our review have increased companies' revenues or may decrease companies' expenses. Crop prices and premium rates increased in 1996 and 1997, generating higher premiums. This had the effect of increasing FCIC's expense reimbursement to companies. At the same time, companies' expenses associated with crop insurance sales and service could decrease as FCIC reduces the administrative requirements with which the companies

[1]Crop Insurance: Opportunities Exist to Reduce Government Costs for Private-Sector Delivery (GAO/RCED-97-70, Apr. 17, 1997).

must comply. Combined, all these factors indicate that FCIC could lower the reimbursement to a rate in the range of 24 percent of premiums and still amply cover reasonable company expenses for selling and servicing federal crop insurance policies.

Regarding the cost of catastrophic insurance delivery, we found that, in 1995, the government's total costs to deliver catastrophic insurance were less through USDA than private companies. Although the basic costs associated with selling and servicing catastrophic crop insurance through USDA and private companies were comparable, total delivery costs were less through USDA because USDA's delivery avoids the need to pay an underwriting gain to companies. In 1995, the underwriting gains paid to participating companies for catastrophic insurance totaled about $45 million. In 1996, the underwriting gains paid for catastrophic insurance were about $58 million.

Finally, we identified a number of different approaches to reimbursing companies for their administrative expenses that offer the opportunity for cost savings. Each has advantages and disadvantages when compared with the existing reimbursement arrangement. Companies generally prefer the existing reimbursement method because of its relative administrative simplicity.

Background

Federal crop insurance protects participating farmers against the financial losses caused by events such as droughts, floods, hurricanes, and other natural disasters. In 1995, crop insurance premiums were about $1.5 billion. USDA's Risk Management Agency administers the federal crop insurance program through FCIC. Federal crop insurance offers farmers two primary types of insurance coverage. The first—called catastrophic insurance—provides protection against extreme crop losses for the payment of a $50 processing fee, whereas the second—called buyup insurance—provides protection against more typical smaller crop losses in exchange for a premium paid by the farmer. FCIC conducts the program primarily through private insurance companies that sell and service federal crop insurance—both catastrophic and buyup—for the federal government and retain a portion of the insurance risk. FCIC also offers catastrophic insurance through the local offices of USDA's Farm Service Agency.

FCIC pays the companies a fee, called an administrative expense reimbursement, that is intended to reimburse the companies for the

expenses reasonably associated with selling and servicing crop insurance to farmers. The reimbursement is calculated as a percentage of the premiums received, regardless of the expenses incurred by the companies. Beginning in 1994, companies were required to report expenses in a consistent format following standard industry guidelines to provide FCIC with a basis for establishing future reimbursement rates. For buyup crop insurance, FCIC reduced the administrative expense reimbursement from a base rate of 34 percent of the premiums on policies sold from 1988 through 1991 to 31 percent of the premiums from 1994 through 1996. The 1994 reform act requires FCIC to reduce the reimbursement rate to no more than 29 percent of total premiums in 1997, no more than 28 percent in 1998, and no more than 27.5 percent in 1999. FCIC can set the rate lower than these mandated ceilings. In addition, the companies earn profits when insurance premiums exceed losses on policies for which they retain risk. These profits are called underwriting gains. Since 1990, companies selling crop insurance have earned underwriting gains totaling more than $500 million.

FCIC had agreements with 22 companies in 1994 and 19 companies in 1995 to sell and service federal crop insurance. In 1995, the insurance companies sold about 80 percent of all federal crop insurance, while USDA's Farm Service Agency sold the remainder. In performing our review, we examined expenses at nine companies representing about 85 percent of the total federal crop insurance premiums written by private companies in 1994 and 1995. We chose the companies considering factors such as premium volume, location, and type of ownership.

Current Reimbursements Exceed Delivery Expenses

In 1994 and 1995, FCIC's administrative expense reimbursements to participating companies selling buyup insurance—31 percent of premiums—were higher than the expenses that can be reasonably associated with the sale and service of federal crop insurance. For the 2-year period, FCIC reimbursed the nine companies we reviewed about $580 million. For this period, the companies reported expenses of about $542 million to sell and service crop insurance—a difference of about $38 million. However, our review showed that about $43 million of the companies' reported expenses could not be reasonably associated with the sale and service of federal crop insurance. Therefore, we believe that these expenses should not be considered by FCIC in determining an appropriate future reimbursement rate for administrative expenses. Furthermore, we found that a number of the reported expenses appeared excessive for reimbursement through a taxpayer-supported program and suggest an

opportunity to further reduce future reimbursement rates for administrative expenses. Finally, a variety of factors have emerged since the period covered by our review that have increased companies' revenues or may decrease their expenses, such as higher crop prices and premium rates and reduced administrative requirements. These factors should be considered in determining future reimbursement rates.

Some Reported Expenses Not Reasonably Associated With Crop Insurance Delivery

Our review showed that about $43 million of the companies' reported expenses could not be reasonably associated with the sale and service of federal crop insurance. These expenses, which we believe should not be considered in determining an appropriate future reimbursement rate for administrative expenses, included expenses for acquiring competitors' businesses, protecting companies from underwriting losses, sharing company profits through bonuses or management fees, and lobbying expenses.

Among the costs reported by the crop insurance companies that did not appear to be reasonably associated with the sale and service of crop insurance to farmers were those related to costs the companies incurred when they acquired competitors' business. These costs potentially aided the companies in vying for market share and meant that one larger company, rather than several smaller companies, was delivering crop insurance to farmers. However, this consolidation was not required for the sale and service of crop insurance to farmers, provided no net benefit to the crop insurance program, and according to FCIC, was not an expense that FCIC expected its reimbursement to cover. For example, one company took over the business of a competing company under a lease arrangement. The lease payment totaled $3 million in both 1994 and 1995. About $400,000 of this payment could be attributed to actual physical assets the company was leasing, and we recognized that amount as a reasonable expense. However, the remaining $2.6 million—which the company was paying each year for access to the former competitor's policyholder base—provided no benefit to the farmer and no net value to the crop insurance program. Likewise, we saw no apparent benefit to the crop insurance program from the $1.5 million the company paid executives of the acquired company over the 2-year period as compensation for not competing in the industry. In total, we identified costs in this general category totaling about $12 million for the 2-year period.

We also found that two companies included payments to commercial reinsurers among their reported crop insurance delivery expenses. These are payments the companies made to other insurance companies to expand their protection against potential underwriting losses. This commercial reinsurance allows companies to expand the amount of insurance they are permitted to sell under insurance regulations while limiting their underwriting losses. The cost of reinsurance relates to company decisions to manage underwriting risks rather than to the sale and service of crop insurance to farmers. We discussed this type of expense with FCIC, and it agreed that this expense should be paid from companies' underwriting revenues and thus should not be considered in determining a future reimbursement rate for administrative expenses. For the two companies that reported reinsurance costs as an administrative expense, these expenses totaled $10.7 million over the 2 years.

Furthermore, we found that some companies included as administrative expenses for selling and servicing crop insurance, expenses that resulted from decisions to distribute profits to (1) company executives and employees through bonuses or (2) parent companies through management fees. We found that profit-sharing bonuses were a significant component of total salary expenses at one company, equaling 49 percent of basic salaries in 1994 and 63 percent in 1995. These bonuses totaled $9 million for the 2 years. While company profit sharing may benefit a company in competing with another company for employees, the bonuses do not contribute to the overall sale and service of crop insurance or serve to enhance program objectives. Furthermore, while we recognize that performance-based employee bonuses and bonuses paid to agents represent reasonable expenses, the profit-sharing bonuses in this example did not appear to be reasonable program expenses because they were paid out of profits after all necessary program expenses were paid. Additionally, we identified profit-sharing bonuses totaling $2.1 million reported as expenses at three other companies for 1994 and 1995. In total, we found expenditures in this general category amounting to $12.2 million over the 2 years.

Similarly, we noted that two companies reported expenditures for management fees paid to parent companies as crop insurance administrative expenses. Company representatives provided few examples of tangible benefits received in return for their payment of the management fee. We recognized management fees as a reasonable program expense to the extent that companies could identify tangible benefits received from parent companies. Otherwise, we considered

payment of management fees to be a method of sharing income with the parent company and paid in the form of a before-profit expense item rather than a dividend. These expenses totaled $1.1 million for the 2 years.

FCIC's standard reinsurance agreement with the companies precludes them from reporting expenditures for lobbying as crop insurance delivery expenses. Despite this prohibition, we found that the companies included a total of $418,400 for lobbying in their expenses reported for 1994 and 1995. The vast majority of these expenses involved the portion of companies' membership dues attributable to lobbying by crop insurance trade associations.

Adjusting for these and other expenses reported in error, we determined, and FCIC concurred, that the expense rate for companies' expenses reasonably associated with the sale and service of buyup crop insurance in 1994-95 was about 27 percent of premiums. This is about 4 percentage points, or $81 million, less than the reimbursement FCIC provided. Of these 4 percentage points, 2 points reflect companies' reported expenses that were less than their reimbursement; the remainder reflect adjustments to their reported expenses that did not appear to be reasonably associated with the sale and service of crop insurance.

Other Reported Expenses Represent Opportunities to Lower Reimbursement Rates

In addition, we found a number of expenses reported by the companies that, although associated with the sale and service of crop insurance, seemed to be excessive for a taxpayer-supported program. While difficult to fully quantify, these types of expenditures suggest that opportunities exist for the government to reduce its future reimbursement rate for administrative expenses while still adequately reimbursing companies for the reasonable expenses of selling and servicing crop insurance policies.

For example, in the crop insurance business, participating companies compete with each other for market share through the sales commissions paid to independent insurance agents. To this end, companies offer higher commissions to agents to attract them and their farmer clients from one company to another. When an agent switches from one company to another, the acquiring company increases market share, but there is no net benefit to the crop insurance program. On average, the nine companies in our review paid agents sales commissions of 16 percent of buyup premiums they sold in 1994 and 16.2 percent in 1995. However, one company paid more—an average of about 18.1 percent of buyup premiums sold in 1994 and 17.5 percent in 1995. When this company, which

accounted for about 15 percent of all sales in these 2 years, is not included in the companies' average, commission expenses for the other eight companies averaged 15.6 percent of buyup premiums in 1994 and 15.8 percent in 1995. This company paid its agents about $6 million more than the amount it would have paid had it used the average commission rate paid by the other eight companies.

Furthermore, in our review of company-reported expenses, at eight of the nine companies, we found instances of expenses that seemed to be excessive for conducting a taxpayer-supported program. For example, we found that one company in our sample for 1994 reported expenses of $8,391 to send six company managers (four accompanied by their spouses) to a 3-day meeting at a resort location. The billing from the resort included rooms at $323 per night, $405 in golf green fees, $139 in charges at a golf pro shop, and numerous restaurant and bar charges. Our sample for 1995 included a $31,483 billing from the same resort for lodging and other costs associated with a company "retreat" costing $46,857 in total. In another instance, as part of paying for employees to attend industry meetings at resort locations, we found that one company paid for golf tournament entry fees, tickets to an amusement park, spouse travel, child care, and pet care, and reported these as crop insurance delivery expenses.

Our review of companies' expenses also showed that some companies' entertainment expenditures appeared excessive for selling and servicing crop insurance to farmers. For example, one company spent about $44,000 in 1994 for a Canadian fishing trip for a group of company employees and agents. It also spent about $18,000 to rent and furnish a sky box at a baseball stadium. Company officials said that the expenditures were necessary to attract agents to the company. These expenditures were reported as travel expenses in 1994 and as advertising expenses in 1995. Moreover, the company's 1995 travel expenses included $22,000 for a trip to Las Vegas for several company employees and agents. Similarly, our sample of companies' expenditures disclosed payments for season tickets to various professional sports events at two other companies; and six companies paid for country club memberships and related charges for various company officials and reported these as expenses to sell and service crop insurance. While a number of the companies believe that the type of expenses described above are important to maintaining an effective sales force and supporting their companies' mission, we, along with FCIC, believe that most of these expenses appear to be excessive for a program supported by the American taxpayers.

Emerging Factors Have Increased Companies' Revenues

Since the period covered by our review, a variety of factors have emerged that have increased companies' revenues or may decrease companies' expenses. Crop prices and premium rates increased in 1996 and 1997, thereby generating higher premiums. This had the effect of increasing the reimbursements paid to companies for administrative expenses by about 3 percent of premiums without a proportionate increase in workload for the companies.

Moreover, FCIC and the industry's efforts to simplify the program's administrative requirements may reduce companies' workload, thereby reducing their administrative expenses. As of January 1997, FCIC had completed 26 simplification actions and was continuing to study 11 additional potential actions. Neither FCIC nor the companies could precisely quantify the amount of savings that companies can expect from these changes, but they agreed that the changes were necessary and collectively may reduce costs.

Government's 1995 Total Cost to Deliver Catastrophic Insurance Through USDA Was Less Than Through Private Companies

In 1995, the government's total cost to deliver catastrophic insurance policies was less through USDA than through private companies. The total cost to the government to deliver catastrophic insurance consists of three components: (1) the basic sales and service delivery costs, (2) offsetting income from processing fees paid by farmers, and (3) company-earned underwriting gains. When only the first and second components were considered, the costs to the government for both delivery systems were comparable. However, the payment of an underwriting gain to companies, the third component, made the total 1995 cost of delivery through private companies more expensive to the government.

With respect to the first component—basic sales and service delivery costs—the cost to the government was higher in 1995 when provided through USDA. The government's costs for basic sales and service delivery through USDA included expenses associated with activities such as selling and processing policies; developing computer software; training adjusters and adjusting claims. These costs also included indirect or overhead costs, such as general administration, rent, and utilities. Also included in the 1995 direct and indirect costs for USDA's delivery were the Department's one-time start-up costs for establishing its delivery system. Direct costs for basic delivery through USDA amounted to about $91 per crop policy, and indirect costs amounted to about $42 per crop policy, for a total basic delivery cost to the government of about $133 per crop policy. The basic delivery cost to the government for company delivery consisted of the

administrative expense reimbursement paid to the companies by FCIC and the cost of administrative support provided by USDA's Farm Service Agency. The administrative expense reimbursement paid to the companies amounted to about $73 per crop policy, and USDA's support costs amounted to about $10 per crop policy, for a total basic delivery cost to the government for company delivery of about $83 per crop policy.

The second component—offsetting income from farmer-paid processing fees—reduced the basic delivery costs to the government for both delivery systems. For USDA's delivery, processing fees paid by farmers and remitted to the Treasury reduced the government's basic delivery cost of about $133 by an average of $53 per crop policy. For company delivery, fees paid by farmers and remitted to the government reduced the government's basic delivery cost of about $83 by $7 per crop policy. For company delivery, the effect on the cost to the government was relatively small because the 1994 reform act authorized the companies to retain the fees they collected from farmers up to certain limits. Only those fees that exceeded these limits were remitted back to the government. Combining the basic sales and service delivery costs and the offsetting income from farmer-paid processing fees, the government's costs were comparable for both delivery systems.

The third component—underwriting gains paid by FCIC only to the companies—is the element that made delivery through the companies more expensive in 1995. The insurance companies can earn underwriting gains in exchange for taking responsibility for any claims resulting from those policies for which the companies retain risk. In 1995, companies earned an underwriting gain of an estimated $45 million, or about a 37-percent return, on the catastrophic premiums for which they retained risk. This underwriting gain increased the government's delivery cost for company delivery by $127 per crop policy. Underwriting gains are, of course, not guaranteed. In years with a high incidence of catastrophic losses, companies could experience net underwriting losses, meaning that they would have to pay out money from their reserves in excess of the premium paid to them by the government, potentially reducing the government's total cost of company delivery in such years.

The 37-percent underwriting gain received by the companies on catastrophic policies in 1995 substantially exceeded FCIC's long-term target. According to FCIC, the large underwriting gains in 1995 may have been unusual in that there were relatively few catastrophic loss claims and many farmers did not provide sufficient data on their production

capabilities. In 1996, however, the underwriting gains on catastrophic policies were even higher—$58 million.

Alternative Reimbursement Arrangements Offer Potential for Savings

The current arrangement for reimbursing companies for their administrative expenses—under which FCIC pays private companies a fixed percentage of premiums—has certain advantages, including ease of administration. However, expense reimbursement based on a percentage of premiums does not necessarily reflect the amount of work involved to sell and service crop insurance policies. Alternative reimbursement arrangements, including, among others, those that would (1) cap the reimbursement per policy or (2) pay a flat dollar amount per policy plus a reduced fixed percentage of premiums, offer the potential to better match FCIC's reimbursements with companies' administrative expenses. Each alternative has advantages and disadvantages, and we make no recommendation concerning which alternative, if any, should be pursued.

With respect to the first alternative, FCIC could reduce its total expense reimbursements to companies by capping, or placing a limit on, the amount it reimburses companies for the sale and service of crop insurance policies. Savings would vary depending on where the cap is set. Capping the expense reimbursement at around $1,500 per policy, for example, would result in a potential savings of about $74 million while affecting less than 10 percent of the individual policies written in 1995. Under the current reimbursement arrangement, as policy premiums increase, the companies' reimbursement from FCIC for administering the policies increases. However, the workload, or cost, associated with administering the policy does not increase proportionately. Therefore, for policies with the highest premiums, there is a large differential between FCIC's reimbursement and the costs incurred to administer those particular policies. For example, in 1995, the largest 3 percent of the policies received about one-third of the total reimbursement. In fact, the five largest policies in 1995 generated administrative expense reimbursements ranging from about $118,000 to $472,000.

Alternatively, FCIC could reduce its total expense reimbursements to companies by paying a flat dollar amount per policy plus a reduced fixed percentage of premiums. FCIC could reimburse companies a fixed amount for each policy written to pay for the fixed expenses associated with each policy as well as a percentage of premium to compensate companies for the variable expenses associated with the size and value of a policy. For example, paying a flat $100 per policy plus 17.5 percent of premium could

result in a potential savings of about $67 million. FCIC has included this alternative in its proposed 1998 standard reinsurance agreement with the industry.

As we discuss in more detail in our report, while these and other alternative reimbursement methods could result in lower cost reimbursements to insurance companies, some methods may increase FCIC's own administrative expenses for reporting and compliance. Some alternatives may also assist smaller companies to compete more effectively with larger companies and/or encourage more service to smaller farmers than does the current system. Companies generally prefer FCIC's current reimbursement method because of its administrative simplicity.

In conclusion, we recommended that the Administrator of the Risk Management Agency determine an appropriate reimbursement rate for selling and servicing crop insurance and include this rate in the new reinsurance agreement currently being developed between FCIC and the companies. Furthermore, we recommended that the Administrator explicitly convey the type of expenses that the administrative reimbursement is intended to cover. USDA's Risk Management Agency agreed with our recommendations and has included these changes in the proposed 1998 agreement now being developed.

The crop insurance industry disagreed with the methodology, findings, conclusions, and recommendations presented in our report. It expressed concern that we were not responsive to the mandate in the 1994 act and did not appropriately analyze company data. It also expressed concern that implementing GAO's recommendations could destabilize the industry. We carefully reviewed the industry's comments and continue to believe that our report fulfills the intent of the mandate, our methodology is sound, our report's findings and conclusions are well supported, and our recommendations offer reasonable suggestions for reducing the costs of the crop insurance program.

This completes my prepared statement. I will be happy to respond to any questions you may have.

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