The 2011 SRA: A Chronology and Assessment

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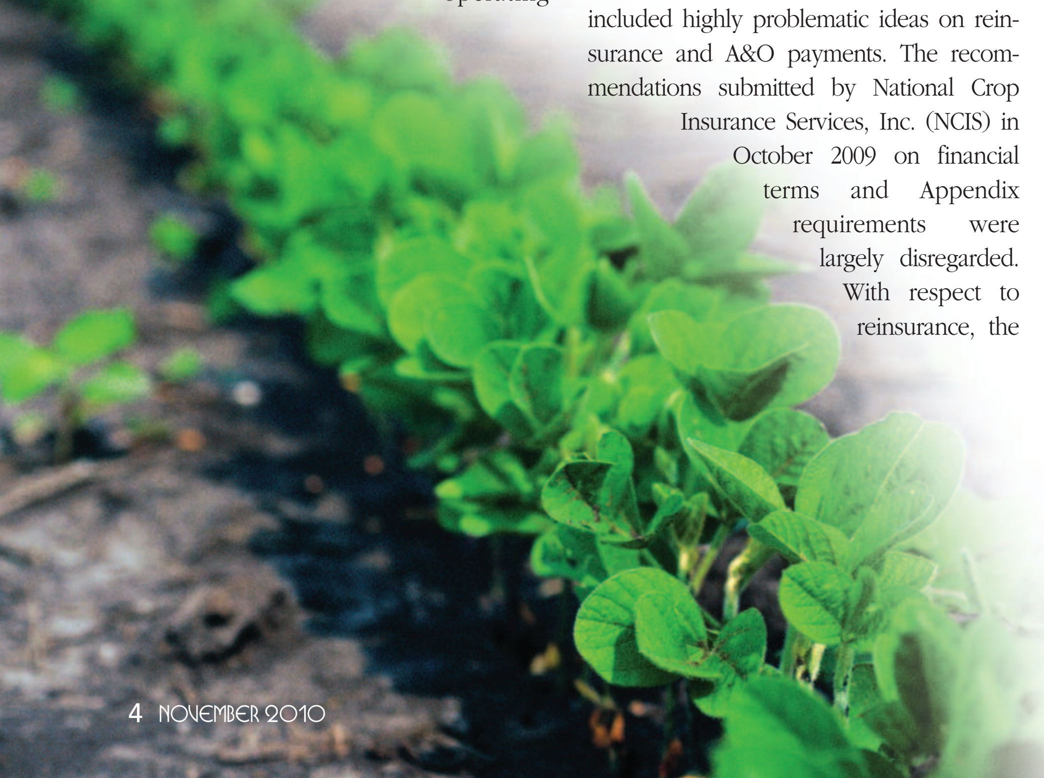
The 2008 Farm Bill

The Standard Reinsurance Agreement (SRA) is the foundation of the public/private partnership responsible for delivering the Federal Crop Insurance program to eligible farm producers. This agreement, between the Federal Crop Insurance Corporation and the 16 policy issuing companies, defines the financial terms and requirements that companies accept in order to participate in the program. As part of the 2008 Farm Bill, the Risk Management Agency (RMA) was authorized to renegotiate the SRA for the 2011 reinsurance year and once in each subsequent five-year period. The 2008 Farm Bill also implemented sharp cuts in expense reimbursements (known as administration and operating expense payments, or A&O) and delayed the timing of payments to companies. As estimated by the Congressional Budget Office, these changes reduced Federal expenditures for the program by $6.4 billion over a 10-year period. The purpose of the following discussion is to highlight the chronology of events during the course of the negotiation process for the 2011 SRA as well as to identify the major elements of RMA's proposed revisions to the financial terms of the agreement.

First Draft of the SRA

Following the program funding reductions legislated in the 2008 Farm Bill, RMA opened the SRA negotiations in December 2009 with an initial proposal for further cuts in unprecedented amounts. From Industry's point of view, the December proposal included highly problematic ideas on reinsurance and A&O payments. The recommendations submitted by National Crop Insurance Services, Inc. (NCIS) in October 2009 on financial terms and Appendix requirements were largely disregarded. With respect to reinsurance, the SRA proposal called for two reinsurance funds, a Commercial Fund for each state and a Residual Fund which merged the high risk business from every company into a single countrywide pool with company retention increased to 100 percent. The proposal eliminated the Developmental Fund and established the Residual Fund as a replacement for the separate Assigned Risk Funds for each state. The Revenue, CAT, and Other sub-funds within the Commercial Fund were eliminated, and states were divided into four groups with different gain/loss provisions in an attempt to rebalance profitability across states. The proposed reinsurance terms for the Commercial Fund would have reduced the potential losses somewhat for companies in years with underwriting losses but would have sharply reduced potential gains in years with underwriting gains. The initial draft SRA also increased Net Book Quota Share from five percent of a company's cumulative underwriting gain or loss under the 2005 SRA to 10 percent, with vague language referring to possibly returning part or all of the increase to the companies. The upshot of these proposals would have been a dramatic reduction in underwriting gains compared with historic program returns.

With regard to A&O, the December 2009 draft SRA modified the method used to establish A&O payments for seven major crops representing about 85 percent of the program. Under RMA's proposal, the premium used to compute A&O would be reduced whenever crop prices exceeded RMA reference prices, which were defined as 1999-2008 average prices received by farmers. The proposed reference prices



were substantially below actual crop prices in recent years. NCIS estimated that the use of reference prices would have reduced A&O by another 32 percent on top of the estimated 12 percent cut imposed by the 2008 Farm Bill. Moreover, underserved states and states that provided low returns to insurers would have faced large reductions, worsening already weak incentives to write business in these states.

NCIS and the private crop insurance companies presented RMA with a litany of objections to the reinsurance provisions of this initial draft SRA. The primary objections were that the proposed gain/loss provisions would excessively reduce returns below historical rates; they did not reflect the loss experience for some of the states assigned to the various groups; and they reduced the role of private reinsurance and thereby put the taxpayer at greater risk. RMA defended the reductions in underwriting gains by relying on the findings of two studies prepared by Milliman, Inc. on the actual rate of return on equity since 1989 and on what should constitute a reasonable rate of return on equity. The Milliman studies were rebutted on several grounds: that they estimated the equity of the crop insurance industry using a model that did not take into account actual company equity or the government's own regulatory requirements for equity of participating crop insurance providers; that Milliman failed to consider reinsurance and actual company expenses; and that the time period considered was not long enough to properly account for the potential of catastrophic loss events.

NCIS and the private crop insurance companies objected to the A&O reductions primarily because they believed (supported by independent legal review) that it would be illegal to calculate A&O payments using a proxy premium in place of the actual premium used to calculate the loss ratio, as stated in statute. RMA defended the A&O cuts on the basis that high market prices were resulting in windfall A&O payments unrelated to increased workloads. Overall, RMA estimated that the proposals in the initial SRA draft would reduce program funding by $8.4 billion over 10 years, which was on top of the $6.4 billion in cuts implemented by the 2008 Farm Bill.

Second Draft of the SRA

RMA responded to NCIS and the private crop insurance companies objections with a second proposal in February 2010. This followed the same general design as the first SRA proposal but offered a few minor changes. The Residual Fund was still included but no longer pooled experience across companies. This addressed the concern that companies would be financially responsible for the actions of their competitors as well as the regulatory issue arising from the possibility that a company would be required to book premium in states where it was unlicensed. Retention for the Residual Fund was reduced from 100 percent to 50 percent, though this still posed a significant challenge to companies by limiting their capacity for writing business due to its impact on premium-to-surplus ratios. This problem would have been especially severe for companies operating in the low return and underserved states, where a high proportion of business is currently placed in the Assigned Risk fund. The number of state groups for the Commercial Fund was reduced from four to three, though groups 2 and 3 used identical gain/loss provisions and differed only for purposes of Net Book Quota Share. Net Book Quota Share was reduced from 10 percent to 7.5 percent, with a third of these funds to be redistributed to companies participating in the group 3 states, but not to exceed the amount of A&O in those states. As in RMA's earlier proposal, group 1 consisted of the five Corn Belt states of Illinois, Indiana, Iowa, Minnesota, and Nebraska. Group 3 included Alaska and the 16 underserved states as defined by USDA, with the remaining 28 states assigned to group 2. Companies would retain a larger share of both gains and losses in group 1 states as compared to RMA's earlier proposal, but would absorb a greater share of the loss and keep less of the gain than under the existing SRA. In state groups 2 and 3, companies would retain more of the underwriting gain than under the first proposal, while the company share of underwriting loss rose in some states and fell in others. Overall, this proposal improved profitability in state group 3 as compared to the existing SRA, offered a modest improvement in several group 2 states, reduced profitability in several other group 2 states, and resulted in large

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cuts to profitability in the group 1 states.

The February SRA proposal also retained the use of reference prices for establishing A&O but proposed a two-year transition period with price bumps of 10 percent and five percent, respectively, prior to full phase-in. The strict linkage of reference prices to 1999-2008 average prices was relaxed with the use of reference prices that were five percent higher in state groups 2 and 3 than in group 1 states. The February proposal also introduced the soft cap, which capped agent compensation other than profit sharing to no more than 80 percent of A&O on a per-policy basis. The amount of profit sharing a company could pay to its agents was limited in aggregate, not to exceed the company's net underwriting gain adjusted for external reinsurance. No restrictions were placed on how these funds could be allocated to individual agents.

In general, Industry had many of the same concerns with this proposal as it had with the first draft. The response submitted by NCIS also noted that various indicators of delivery expenses other than commissions have risen over time and that RMA had not given these cost increases due consideration. The response also emphasized the importance of benchmarking industry profitability against real-world industries rather than against the less than persuasive financial models employed by Milliman. In addition, NCIS noted that RMA had provided little or no supporting information or analytical models, which raised concerns whether RMA's conclusions were justified. Overall, the second SRA proposal was considered by the companies to be an improvement over the original, but still far from acceptable.

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Third Draft of the SRA

The third draft introduced yet another approach for stabilizing A&O payments by capping A&O for 2011 at a fixed amount with an inflation adjustment in future years. Area plans, CAT business, and new crop/county programs were excluded from the cap. This proposal had the advantage of eliminating the reference price approach that NCIS and the private crop insurance companies found so problematic. While the reference price approach would have been effective in stabilizing the price level component underlying the A&O calculations, it failed to address the impact of price volatility on Revenue plan rates which indirectly affected A&O. The reference price approach would have reduced A&O volatility to some extent but at the expense of a large A&O reduction which could have disrupted program delivery in a number of states. In total, A&O in 2011 under the new procedure was expected to be close to the amount of A&O estimated for 2010.

In addition to capping A&O, the third draft introduced a lower limit on A&O payments; however, this provision is not legally binding without further legislative action. It also revised the 80 percent soft cap on agent compensation to apply to a company's total A&O in each state rather than separately by policy or by agent. Total agent compensation, including both commissions and profit sharing, was limited by a hard cap of 100 percent of the A&O received by the company in that state. This was an entirely new provision that had not been discussed prior to release of the third draft. To prevent companies from paying out more in profit sharing than their actual profits, the additional amount payable under the hard cap was limited to the company's actual underwriting gain adjusted for Net Book Quota Share and external reinsurance. This limitation, which applies separately to each state, prevents a company from using profits in one state to compensate agents in other states. Its intended purpose is to ensure a level playing field for companies that operate only in the higher risk and underserved states. The test of whether companies are in compliance with this provision is conducted at the first annual settlement date, roughly 16 months after the end of the reinsurance year. One complication is that the SRA did not specify the types of expenditures and benefits to be included in the definition of agent compensation. At present, NCIS and Industry are working with RMA to resolve this issue.

In terms of underwriting gain and loss provisions, the third draft retained the basic structure of the second draft with some minor improvements. The three state groups for the Commercial Fund were unchanged. The third draft restored the separate Assigned Risk Funds for each state in place of the countrywide Residual Fund in the prior draft. The mandated retention rate for Assigned Risk was cut to 20 percent, greatly reducing the strain on company capacity in writing the program. Underwriting gain/loss provisions for the Commercial Fund in the group 1 states were unchanged from the previous draft. Profitability in state groups 2 and 3 improved modestly, with companies retaining slightly more of the underwriting gains and slightly less of the underwriting losses. Net Book Quota Share was reduced from 7.5 percent to 6.5 percent, with 1.5 points to be redistributed to companies operating in state group 3, provided that Net Book Quota Share generated an underwriting gain in the year for all states combined.

Final Draft of the SRA

The fourth and final draft of the SRA, released on June 30, 2010, was presented to the industry with the stipulation that RMA would reject the submission of any company that signed the SRA but reserved its rights to sue over the terms of the agreement. Though the provisions on reference prices and the Residual Fund were eliminated, the final SRA introduced an unprecedented level of funding reductions, estimated by RMA to total $6 billion over 10 years, which will necessitate painful company and agent adjustments in the future. Despite these challenges, every company participating in the program elected to sign the SRA. However, this did not bring final closure to the SRA process. Certain implementation issues, such as the definition of agent compensation, the method for implementing the cap on A&O, and several other items, still remain to be resolved.

Summary

The 2011 SRA represents a watershed in terms of the degree of government involvement in the program. With the introduction of the soft and hard caps, RMA is now directly involved in issues relating to agent compensation and in ensuring company compliance with these provisions. The upper limit on A&O introduced in the 2011 SRA creates a further obstacle for companies in that the amount of A&O they receive to deliver the program will not be known with any certainty until after the year has ended. This complicates their efforts in paying agents, especially since compensation is now limited to a percentage of the amount of A&O received. Companies have also expressed a concern that the delay in determining A&O will make it more difficult to record revenue on their books in a timely and accurate manner. The introduction of state groups, with the intent of managing the potential for underwriting gain and loss, is another step toward greater governmental involvement in the economic aspects of the program. No doubt, there are many other unforeseen and unintended consequences of the 2011 SRA yet to be discovered. Despite these concerns, NCIS and the private crop insurance companies have accepted their responsibility to work with RMA to identify and address unresolved implementation issues to ensure the successful introduction of the new SRA and are committed to moving forward to do everything possible to ensure that farmers continue to receive the high level of service they have benefitted from in the past.