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by Alan P. Ker ■ In Short

Private Insurance Companies and the U.S. Crop Insurance Program

It appears that political forces want to fashion crop insurance as the cornerstone of U.S. agricultural policy. In his 1999 State of the Union Address, President Clinton stated,

> As this Congress knows very well, dropping prices and the loss of foreign markets have devastated too many family farmers. Last year, the Congress provided substantial assistance to help stave off a disaster in American agriculture, and I am ready to work with lawmakers of both parties to create a farm safety net that will include *crop insurance reform* and farm income assistance (emphasis added).

Similarly, in his radio address of 28 December 1998, Secretary of Agriculture Dan Glickman emphasized that

> Of course, this past year was about more than crisis management. We expanded *crop insurance* and experimented with innovative kinds of coverage, such as whole-farm coverage. It's no secret that I want 1999 to be the "year of the safety net"... a year in which we build a strong risk management system anchored in a strengthened *crop insurance program* (emphasis added).

In the past, crop insurance offered farmers the opportunity to insure against yield losses resulting from nearly all risks, including drought, fire, flood, hail, and pests. For example, if a farmer's expected corn yield is 150 bushels/acre, a contract purchased at the 60 percent coverage level insures against a realization below 90 bushels/acre (0.6 x 150 bushels/acre = 90 bushels/acre). If the yield reached only 75 bushels/acre, the farmer would receive an indemnity payment for the insured value of 15 bushels/acre.

Private insurance companies and the U.S. Department of Agriculture's Risk Management Agency (RMA) now provide a variety of crop insurance plans, and a number of new pilot programs are under development. Standard crop yield insurance, termed Multiple Peril Crop Insurance, pays an indemnity at a predetermined price to replace yield losses. "Group-risk" yield insurance, termed Group Risk Plan, is based upon the county's yield. Insured farmers collect an indemnity when the county average yield falls beneath a yield guarantee, regardless of the farmers' actual yields. Three farm-level revenue insurance programs are also available for a limited number of crops and regions: Crop Revenue Coverage, Income Protection, and Revenue Assurance. These programs guarantee a minimum level of crop revenue and pay an indemnity if revenues fall beneath the guarantee (Goodwin and Ker). The recently developed Group Risk Income Plan, a variation of the Group Risk Plan, insures county revenues rather than yields (Baquet and Skees).

Private insurance companies actively participate in these crop insurance programs and warrant attention. Recent history indicates that a sizable portion of federal outlays for crop insurance programs came to rest with the insurance companies, approximately 32 percent over the 1995 to 1998 period. As Congress continues to funnel large sums of money into the programs, two very important questions deserve consideration. Why has such a large proportion of the monetary outlay for the crop insurance programs gone to the insurance companies instead of to farmers? Should insurance companies continue to operate as in the past? The drain of the crop insurance programs on the federal budget and the long-run survival of the programs depend upon answers to these questions.

How insurance companies now operate

While the RMA sets or approves the premium rates and provides premium subsidies to producers, the insurance companies sell policies and conduct claim adjustments. In return for performing these administrative activities, insurance companies receive compensation from the RMA. Currently, they receive 24.5¢ for every unsubsidized premium dollar on most yield-based products. The compensation varies among product types.

The profit [loss] associated with an insurance policy is termed the underwriting gain [loss]. The Standard Reinsurance Agreement (SRA) stipulates the terms by which insurance companies and the RMA share underwriting gains and losses of the policies. These terms, which have changed over the years, are now set in a statute (Ker, and Miranda and Glauber provide in-depth analyses of the SRA). Section II.A.2 of the 1998 SRA states that an insurance company "...must offer all

approved plans of insurance for all approved crops in any State in which it writes an eligible crop insurance contract and must accept and approve all applications from all eligible producers." An eligible farmer will not be denied access to an available federally subsidized crop insurance product. Therefore, an insurance company wishing to conduct business in a state cannot discriminate among farmers, crops, or insurance products in that state. An unusual situation arises: the responsibility for pricing the crop policies lies with the RMA but the insurance company must accept some liability for each policy they sell and cannot choose which policies they will or will not sell.

Why are insurance companies willing to share the underwriting gains and losses of policies they must sell but do not price? First, the SRA provides a mechanism by which insurance companies can cede almost all liability of policies they deem undesirable. Under the SRA, the insurance company must place each policy sold into one of three funds with varying levels of risk sharing. For policies placed in the "assigned risk fund," the insurance company accepts a negligible share of the underwriting gains and losses. Second, under the SRA, the asymmetric sharing of underwriting gains and losses provides a mechanism by which insurance companies enjoy a return on their capital. No one knows if this return to capital is inflated relative to a private market with similar risks.

Between 1995 and 1998, insurance companies received approximately $1.7 billion in administrative fees and $1.1 billion in underwriting gains for a total of $2.8 billion. To put these figures in perspective, premiums totaled $7.0 billion, premium subsidies to producers totaled $3.6 billion, and underwriting gains for both the insurance companies and the RMA totaled $1.3 billion over this same four-year period (USDA-OIG). Insurance companies received 83.5 percent of the underwriting gains. Admittedly, these were relatively good years for agriculture. In 1993, the total underwriting loss for the program reached $832 million; the insurance companies absorbed just under 10 percent ($82 million) of that loss.

Why has such a large proportion of the federal outlay for crop insurance programs gone to insurance companies instead of to farmers? Simply put, the SRA mechanisms to win private company participation provide sizable transfers from the federal government to the insurance companies.

Should the Standard Reinsurance Agreement (SRA) be changed?

The provisions of the SRA dictate the terms of insurance company participation in crop insurance programs, terms that, as seen above, appear favorable indeed. Might other rules fulfill agricultural policy goals at less public cost? Many unknowns need answers. For example, is the return to insurance company capital, a return embodied in the SRA, inflated relative to returns to capital in other businesses with similar risk? Under the terms of the SRA, insurance companies could inflate the return to their capital by considering forecasts of El Niño/La Niña (Ker and McGowan). To what extent does this and other information inflate the insurance companies' return to their capital? Answers to these questions are needed to make further improvements in the SRA.

USDA/ARS

Even more basically, should private insurance companies participate in the government's crop insurance program? The government brought insurance companies into the program primarily to bolster farmer participation in risk-reducing insurance programs. But might participation be encouraged more if government outlays made to insurance companies went instead to at-risk farmers? ■

■ For more information

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