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Cost & Efficiency Analysis of U.S. Crop Insurance Program: Implications of Additional FSA Responsibilities

Executive Summary

Prepared for:



I. EXECUTIVE SUMMARY

A. Introduction

Crop insurance is of great importance to the health of our agricultural industry, as it protects farmers against floods, drought, hail and other perils which create crop or livestock losses and it reduces the need for ad-hoc disaster payments. The program is currently administered by the United States Department of Agriculture (USDA) Risk Management Agency (RMA). RMA partners with private insurance companies which sell and service the insurance policies. However, over the recent years, there has been increasing debate and program scrutiny pertaining to the costs of the current federal crop insurance program. This is particularly true in light of current economic conditions and government budget negotiations.

Informa Economics, Inc. (Informa) was contracted by the National Association of FSA County Office Employees (NASCOE) to study the feasibility of the Farm Service Agency (FSA) of USDA assuming additional responsibilities related to the federal crop insurance program.

Additional responsibility scenarios analyzed include:

- FSA takes on the role of selling the crop insurance and functions currently performed by the insurance agent.
- FSA takes on the role of servicing the crop insurance and functions currently performed by the insurance company.
- FSA takes on both the sales and servicing role – redirecting functions currently performed by insurance companies and agents.
- Only FSA produced acreage and production reports, a task that is currently duplicated among FSA and RMA offices.

Key cost and efficiency implications resulting from FSA assuming additional responsibilities within the crop insurance program are presented within this executive summary.

B. Key Findings

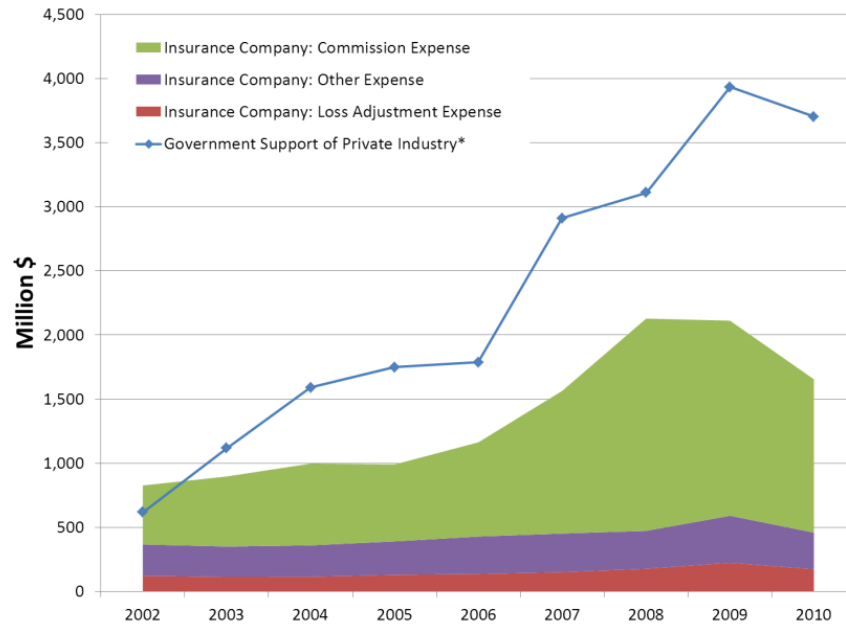
Overview of Current System

Currently, the government reimburses private insurance companies for their expenses incurred to sell and service crop insurance. This reimbursement is based on a percentage of the insurance premiums, which have increased substantially over recent years as crop prices have increased (i.e. A&O Expense Reimbursements). Additionally, these companies retain a portion of the underwriting gains/losses (i.e., gross premiums minus indemnities), which have been positive every year except one since 1995. Crop insurance companies then pay agents to sell the crop insurance and to collect acreage and production data and they pay loss adjusters to investigate loss and damage claims. The potential costs savings resulting from increasing FSA's role in the crop insurance program stems largely from eliminating the \$1.6 billion (5 year average) in underwriting

gains and from estimated savings in the sales cost, as agent commissions have increased significantly over the past decade and are not reflective of actual incurred expenses.

Exhibit 1 illustrates the compensation paid to or retained by private insurance companies for selling and servicing crop insurance and their reported expenses since 2002.

Exhibit 1: Private Insurance Company: Crop Insurance Revenues and Expenses



* A&O expense reimbursement plus underwriting gains retained by insurance companies.
Sources: RMA; Grant Thornton; and Informa Economics

Potential Cost Savings: Expanding FSA's Crop Insurance Responsibilities

Informa's estimates for the potential government cost savings resulting from scenarios which would expand FSA's role in the federal crop insurance program are detailed in Exhibit 2. While there were many assumptions required to compare status quo costs with the costs of redirecting various functions currently performed by the insurance companies and insurance agents to the FSA, even the conservative estimates shown in Exhibit 2 illustrate a significant cost savings for the government. Keeping in mind that the cost estimates presented within this section are intended to be used to establish perspective on the order of magnitude of each scenario, if sales and service functions are shifted from the private industry to the FSA, cost savings estimates are in the order of \$1.9-\$2.5 billion per year.

Exhibit 2: Potential Annual Government Cost Savings by Scenario

	No Change /1 (2006-2010 Avg.)	FSA - Sales and Servicing		FSA - Sales		FSA - Servicing	
		FSA Cost Est.	High FSA Cost Est.	FSA Cost Est.	High FSA Cost Est.	FSA Cost Est.	High FSA Cost Est.
Income (million \$)	7,566	7,566	7,566	7,566	7,566	7,566	7,566
Gross Premium	7,511	7,511	7,511	7,511	7,511	7,511	7,511
Premium Subsidy	4,466	4,466	4,466	4,466	4,466	4,466	4,466
Producer Premium	3,045	3,045	3,045	3,045	3,045	3,045	3,045
Interest and Other Income	55	55	55	55	55	55	55
Costs (million \$)	12,339	9,877	10,418	11,667	12,016	10,281	10,473
Premium Subsidy	4,466	4,466	4,466	4,466	4,466	4,466	4,466
Indemnities (loss claims)	4,813	4,813	4,813	4,813	4,813	4,813	4,813
Other Costs	132	132	132	132	132	132	132
Underwriting Gain/(Loss) /2	1,629	-	-	1,629	1,629	-	-
A&O Expense Reimbursements /2	1,300	-	-	481	481	551	551
Est. FSA Costs	-	467	1,007	147	496	320	511
Net Costs (million \$)	4,773	2,311	2,852	4,101	4,450	2,715	2,907
Estimated Cost Savings (million \$)		2,462	1,922	672	323	2,058	1,866

1/ \$1.3 billion is the A&O reimbursement maximum established within the recently renegotiated SRA.

The maximum is utilized, as actual A&O estimates given Informa's outlook on commodity prices would be above the \$1.3 billion cap.

2/ Paid to or retained by private insurance companies. A&O expense reimbursements are paid to insurance companies to reimburse them for their expenses incurred in selling and servicing crop insurance. This amount is based on premiums which are driven by commodity prices. Underwriting gains/losses represent the portion of the total gain/loss (gross premiums minus indemnities/claims) insurance companies are able to retain.

Other Notes:

*This analysis does not examine any changes to the premium subsidy and producer premium.

** The details/methodology of how each of these costs estimates were derived and the assumptions made are provided in the main body of the report.

*** These cost savings estimates do not include costs associated with training and other expenses required in the short-term to transition the various functions from one entity to another.

Source: Informa Economics

The scenarios examined within this study are described below along with the estimated government cost savings relative to the status quo (i.e., maintaining the current insurance company and agent functions). These cost savings estimates do not include costs associated with training and other expenses required in the short-term to transition the various functions from one entity to another.

FSA Sales Only

FSA takes on the role of selling the crop insurance and functions currently performed by the insurance agent.

- A government cost savings of \$323 to \$672 million is estimated.
- These estimates assume adequate FSA staffing to maintain the quality of the federal crop insurance program. It is critical that any change to the program not under cut required staffing levels. Based on a literature review, this is a key

concern many people will have with changing the current program. Even with conservative staffing level assumptions, a sizeable cost savings is estimated.

- In addition to the cost savings, having FSA offices perform the sales function may improve service to underserved areas. This statement is based on:
 - The geographic locations of current agents versus county FSA offices (see Exhibit 3) – insurance agents are highly concentrated in the Midwest and there are other geographies in which farmers must drive a substantial distance to reach their agent.
 - Unlike the current system in which higher commission rates appear to be provided to agents in states with larger underwriting gains, the actual costs of selling crop insurance are not expected to vary significantly based on geography.
- Additionally, many of the insurance agents are currently using FSA production and acreage reports. If the sales function is performed at the FSA office, this would eliminate duplication within the system and reduce system errors.

FSA Service Only

FSA takes on the role of servicing the crop insurance and functions currently performed by the insurance company. Under this scenario, the government would choose how to dispense agent commissions. Additionally, a large portion of the loss adjustment work would likely remain contracted out with private adjusters.

- A government cost savings of \$1.9 to \$2.1 billion is estimated.
 - These estimates assume adequate FSA staffing to maintain the quality of the federal crop insurance program. It is critical that any change to the program not under cut required staffing levels. Based on a literature review, this is a key concern many people will have with changing the current program. Even with conservative staffing level assumptions, a sizeable cost savings is estimated.
- The bulk of this cost savings within this scenario is from savings in the underwriting gains. If the federal crop insurance program was no longer serviced by private insurance companies, the net gain/loss currently retained by private insurance companies would revert to the government.
- While an underwriting loss has not occurred since 2003, this would be revenue foregone in years where there is a net loss, as the government would bear the full cost. However, it can be argued that due to the rules dictated by the Standard Reinsurance Agreement (SRA), the insurance company's portion of the net loss is generally less than their portion of the net gain.

FSA Sales and Service

FSA takes on both the sales and servicing role – redirecting functions currently performed by insurance companies and agents.

- A government cost savings of \$1.9 to \$2.5 billion is estimated.
 - This estimate is considered conservative as it uses the cost estimates for the FSA sales only scenario, plus cost estimates from the FSA service only scenario, yet there would likely be efficiency gains from having FSA do both sales and service relative to each function individually.
- The bulk of this savings is from savings in the underwriting gains.
 - The profit of the private insurance companies may or may not be within reason relative to their risk - this is not the question analyzed within this study. Regardless, this is a profit that insurance companies are receiving in an industry that is subsidized by the government – the federal crop insurance program supports profits for farmers, private insurance companies and insurance agents.

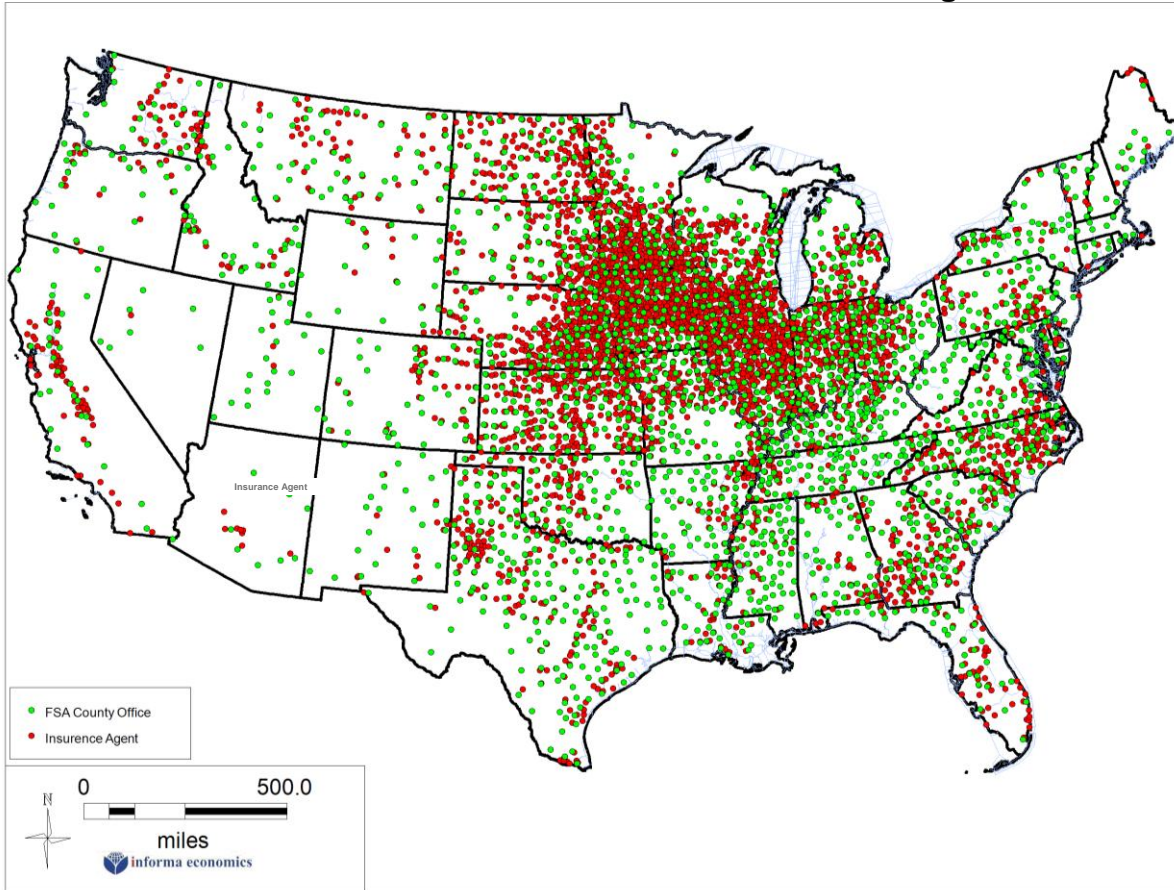
FSA Only Agency Producing Reports

Currently there are duplications in crop acreage and production reporting efforts across the RMA and FSA. Both the FSA and the RMA currently collect production and acreage data. Often the data collected from crop insurance agents is provided by FSA reports and “rekeyed” into their database.

While data is not available to adequately estimate the cost of the current reporting duplication between agencies and the resulting cost savings from resolving the duplication issue, it is clear that steps taken in this direction would provide a cost savings for the government, would benefit and save the farmers time, and would result in a better, more accurate product.

Given that 98% of interviewed FSA offices report sharing their acreage reports with insurance agents, the acreage reporting duplication cost can be roughly estimated by examining the FSA cost of acreage reporting. Based on FSA estimates of number of full time employees required to do acreage reporting and an assumed grade 7 level (step 5) with 35% burden, it currently costs approximately \$197 million for acreage reporting. If it is assumed that it generally costs FSA and the insurance agents roughly the same to do the same thing, this is the cost savings which could be realized if the duplication were eliminated and only FSA did acreage reports.

Exhibit 3: Locations of FSA Offices vs. Insurance Agents



*Each insurance agent dot represents a city in which an agent is located. There may be more than one agent located per city, but only 1 dot is shown.

Source: RMA, FSA