"...Where to now, St. Peter?"

Viability: Tipping Points and Headwinds

Tom Zacharias, NCIS President

This is the last in our three part series "... *Where to now St. Peter?"* that we began earlier this year. The purpose for the series was to start thinking about the future path of the crop insurance industry as we implement the Farm Bill and enter a new paradigm in farm policy. Our physical metaphor is a stable three-legged stool. The first two legs of the stool we discussed were *"Availability"* (*Crop Insurance TODAY*®, May 2014) and *"Affordability"* (*Crop Insurance TODAY*®, September, 2014).

Now we turn our focus to the issue of viability, specifically the economic viability of the private sector delivery system. As one of the three legs of the stool, the "viability" of the private sector delivery system is integral to the health and overall well-being of the crop insurance program.

Viability Defined

Stepping back for a moment, it is important to define a few terms and put our discussion in perspective.

First, the term "viability." In a business context, "viability" can be defined as the "capacity to operate or be sustained" (Dictionary.com); alternatively, "viable" can be defined as "having a reasonable chance of succeeding…financially stable…" (Merriam Webster Online Dictionary).

The Parties Involved

Time and time again in this publication and elsewhere, the expression "public-private partnership" is used to describe the United States crop insurance program. The public element of the partnership is personified by the United States Department of Agriculture (USDA) and the Risk Management Agency (RMA), the Federal agency responsible for administering Federally regulated crop insurance. Responsibilities of the RMA include: the development of crop insurance policies and the underlying procedures, establishment of fair and adequate premium rates, provision of financial support and risk-sharing of premium and losses and regulatory oversight of the crop insurance companies.

The "private" element of the partnership is comprised of the insurance companies, crop insurance agents, crop adjusters and the reinsurance community. Crop insurers are responsible for selling and servicing the policies, equitable and timely adjustment of crop insurance claims and risk-sharing of premiums and losses with USDA/RMA.

In this partnership, there is a key factor that determines the economic viability of the private sector delivery system. Simply put, in order to remain viable, crop insurance companies and the industry as a whole need to generate an adequate return on their investment. The fact that sufficient returns are needed to keep enterprise moving is not an earth-shattering revelation, but it is at the core of the public-private crop insurance partnership, and far too often, it is misunderstood and overlooked.

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Federal Crop Insurance: A Different Business Model

In other lines of insurance, companies set premium rates based on their own loss experience, expenses, and rate of return objectives. This is similar to state-regulated crop-hail insurance.[1] The Federal crop insurance program operates on a different basis. In contrast to conventional lines of insurance, RMA establishes the premium rates that farmers pay. RMA premium rates reflect expected indemnities plus a catastrophic reserve. To keep farmer premium affordable, delivery expenses are not included. In addition, farmer premiums are further discounted.

Program delivery expenses and risk-sharing between USDA and the participating insurance companies are determined through a cooperative financial arrangement known as the Standard Reinsurance Agreement (SRA). The SRA defines the responsibilities of the participating insurance companies (known as Approved Insurance Providers or AIPs) in delivering the program and specifies the financial arrangements under which the companies operate. One section of the SRA establishes the amount of delivery expense the government pays to compensate insurers for their cost of delivering the program. Another section of the agreement defines the risk-sharing arrangement between USDA and the crop insurance companies.

Delivery Expenses

Delivery expenses are treated separately in Federal crop insurance. Farmer premiums do not include an expense component. Technically, the delivery expense component is defined in the SRA as "A&O subsidy," i.e., "administrative and operating (A&O) expenses paid by FCIC (Federal Crop Insurance Corporation) on behalf of the policyholder to the Company…"

Because of this unique feature of the Federal crop insurance program, delivery expense or A&O is often misunderstood. Separating A&O from farmer premium keeps premiums affordable, enabling farmers from all regions greater access to effective coverage. Unfortunately, opponents and critics of crop insurance mis-characterize A&O payments to the companies as profit or subsidy. This is simply not the case. The purpose of A&O is to reimburse

companies for their program delivery expenditures that includes crop insurance agent delivery costs, company office and information technology (IT) expenditures, and company employee salaries. A&O reimbursement rates have fallen dramatically since the early years of private sector delivery. In the early 1980s, A&O as a percent of premium was in excess of 30 percent. Today, A&O as a percent of premium is just over 10 percent. The independent accounting firm of Grant Thornton has documented that the A&O payment does not fully cover the company cost of delivery. (*Federal Crop Insurance Program Profitability and Effectiveness Analysis 2013 Update, June 2014*) This "A&O shortfall" is essentially a benefit to both taxpayers and farmers since companies are providing greater delivery services out of their own pockets.

Risk-Sharing Revenue

As mentioned above, premium rates for the Federal crop insurance program exclude any loading for the insurer's delivery expense and return on investment. Instead, the SRA allows an insurer to retain a portion of the total underwriting gains (defined as the difference between premiums and indemnity payments) produced on its book of business, but it must also cede a portion of the gains to the government. At the same time, the SRA also allows the insurer to cede a portion of any underwriting loss to the government, but it requires the insurer to retain a portion of the loss. Underwriting gains should be considered as risk-sharing revenue. This revenue is not profit nor is it guaranteed—as some contend. What should be kept in mind is that the risk-sharing revenue or loss a company earns in a year depends on weather and crop prices. If weather conditions are favorable and farmers have good crop yields, fewer claims are reported and companies are able to earn positive revenues. In years with poor weather and low crop yields, farmers experience more claims and insurers experience underwriting losses. When poor weather affects a large region, the underwriting losses in those states can exceed the revenues earned throughout the rest of the country. In addition to weather risk, crop insurance policies indemnify farmers for losses in crop prices. The volatility of crop prices in recent years has been a source of concern to the industry. RMA has recently issued a request for comments regarding the price volatility component of its actuarial methodology. It is our hope that this initiative will result in an improved actuarial process in the future.

Because of the potential for widespread losses, often referred to as "systemic losses," crop insurance is much riskier than most other Property & Casualty (P&C) lines of insurance. The higher riskiness of crop insurance can be illustrated by considering how often an insurance industry has underwriting losses. Industry sources report that the P&C industry as a whole has had underwriting losses only once, in 2001, due to the unprecedented attack on the World Trade Center in New York City. In comparison, the crop insurance industry has had underwriting losses in three years over the past two decades: 1993, 2002 and 2012. The program also had underwriting losses in the 1980s: 1983, 1984 and 1988, when the program was much smaller and in its early stage of development.

Why is Risk-Sharing and Return on Investment Important?

Risk-sharing in insurance is essential in order that the insured and the insurer both have "skin in the game." For crop insurance, risk-sharing has several dimensions that benefit not only the farmer but the taxpayer as well. First, the farmer shares in the cost of the premium. This is in sharp contrast to farm and *ad hoc* disaster assistance programs of the past. Second, crop insurance companies share in the risks with the government, reducing taxpayer expense for agricultural disasters. Lastly, be-

[1] The class of crop insurance business that is state-regulated, is commonly referred to as "Crop-Hail" insurance. Crop-Hail insurance coverage is written primarily in the continental United States through companies licensed and regulated by state insurance departments. Coverage is primarily restricted to hail damage to growing crops, although many crop-hail policies contain endorsements for additional insured perils other than hail. Companies writing "crop-hail" coverage set their own individual premium rates using industry loss statistics assembled by our organization, NCIS. The total premium charged to the farmer includes an expected loss component and a load for company expense and a return to risk. Crop-Hail losses are settled by company loss adjusters using loss procedures developed by NCIS on behalf of the industry.

cause crop insurance companies share in the risk, their adjusters have an economic incentive to pay claims accurately. This protects the program from fraud, waste and abuse.

Another critical aspect of risk-sharing is the opportunity for companies to earn a return on their investment. The crop insurance industry has over 20,000 licensed agents, crop adjusters, and company staff. This infrastructure requires a substantial investment, along with the requisite IT support. Crop insurers must receive an adequate return in order to re-invest these earnings and continually maintain and upgrade their operations. This is particularly true with respect to IT investment. By reinvesting in their operations, crop insurers are able to adopt the most current state-of-the-art technologies. Under a publicly administered program, IT procurement would be hamstrung by regulatory bureaucracy. Given the increasing need for risk management in U.S. agriculture and the expanded complexity of farmer choices under the 2014 Farm Bill, it is imperative that crop insurers be able to invest and upgrade their systems.

Tipping Point(s)

With some editorial license, the reference to "tipping point(s)" is attributable to Malcolm Gladwell, Title: ***The Tipping Point: How Little Things Can Make a Big Difference*** (2000). Gladwell defines "tipping point" as "...the moment of critical mass, the threshold, the boiling point…." For our purpose here, I use the term simply to illustrate that recent events have taken place in the crop insurance industry that have "tipped" the scale and threaten the future viability of the private sector delivery system.

The 2008 Farm Bill and the 2011 SRA

One recent tipping point would be the reduction in crop insurance funding as a result of the 2008 Farm Bill. In the 2008 Farm Bill, funding for industry A&O was reduced by $6 billion over ten years, or an average of $600 million annually. A second recent tipping point is the financial terms of the current SRA, which were renegotiated for the 2011 SRA. As a result, funding for A&O was reduced and capped at $ 1.3 billion annually. The risk-sharing provisions of the SRA were revised to reduce industry underwriting gains. The reduction in A&O payments and underwriting gains was estimated by the government to lower company revenues by $6 billion over ten years or another $600 million annually.

The 2012 Drought coupled with Recent Weather and Market Events

After the program changes in the 2008 Farm Bill and the 2011 SRA, the 2012 drought struck. The drought resulted in a record high of more than $17 billion in indemnities and the largest industry underwriting loss in history. Even with record losses the crop insurance industry performed admirably, claims were adjusted timely and the farm sector was able to rebound for the spring of 2013. In addition to the drought of 2012, the United States experienced major flooding along both the Missouri and Mississippi Rivers in 2011 and severe drought in the Southern Plains, acutely in the states of Kansas, Oklahoma, and Texas. Fast forward to 2013 when the dramatic decline in crop prices resulted in widespread losses for crop insurance revenue policies. The program loss ratio (indemnities as a percent of total premium) was again over 100 percent following the 2012 loss ratio of 157 percent. The recent up-tick in weather, or perhaps climate, related disasters coupled with volatile commodity markets should alert the industry and RMA to be ever mindful of the need to maintain actuarial soundness of the program. Recent changes in RMA's actuarial methodology need to be continually monitored to ensure that crop insurance premiums are adequate and accurately reflect the loss experience of the program.

These "tipping points" in revenue streams are the result of both discretionary actions and uncontrollable and unforeseeable events. Taken in isolation, each of these discretionary and uncontrollable events could be managed in the "normal" course of affairs by the crop insurance industry. Taken as a sequence of events with cumulative consequences, crop insurers are left wondering when, and if, the tide will turn. It is also important to note that since 2008 there have been no savings from reduced operational and administrative requirements of the program. In fact, companies and agents have been required to perform more functions and continue to react to catastrophic loss events. In essence, revenues have tipped downward and cost of delivery has increased, resulting in reduced viability of the private sector delivery system.

The 2014 Farm Bill

There should be no question that crop insurance was central to the safety net deliberations in the 2014 Farm Bill. As stated time and time again by agricultural leadership and stakeholders, "Do No Harm to Crop Insurance" was, and remains, the rallying mantra for our industry. In the final analysis, provisions in the 2014 Farm Bill expanded both the ***availability*** and ***affordability*** of crop insurance for farmers. For this we extend our appreciation to Congressional leaders and staff of the House and Senate Agriculture Committees because we believe a better crop insurance program will increase the financial strength of American agriculture.

The 2014 Farm Bill makes available two new major supplemental policies that provide protection against weather disasters and revenue losses. These are the Stacked Income Protection Plan (STAX) and the Supplemental Coverage Option (SCO). Provisions in the 2014 Farm Bill also provide for the availability of new plans of insurance for an array of crops not previously covered. Further, the 2014 Farm Bill improved the affordability of crop insurance for beginning farmers and ranchers and made available significant enhancements to the existing individual coverage, which is the cornerstone of the crop insurance program.

In my mind, the success of the farm safety net as restructured in the 2014 Farm Bill ultimately rests on the success of individual crop insurance coverage and the viability of the private sector delivery system. One has to believe that future Farm Bills will place even greater reliance on the use of risk management and crop insurance. With the implementation of the 2014 Farm Bill, and the emphasis on crop insurance as the primary component of the farm sector safety net, it is more important than ever before for the private sector delivery system to remain effective and economically viable. This greater emphasis on crop insurance will require a greater accountability on the part of the industry. In turn, the Agency will also face greater accountability to help ensure crop insurance remains available, affordable and viable.

The Current Financial Snapshot

Since the inception of the 2011 SRA, returns to the industry have been inadequate to sustain the viability of the delivery system that is needed to fulfill the requirements and expectations of the new Farm Bill. With the exception of 2011, industry underwriting revenues have been negative, as was the case in 2012, or well below government budget projections. In addition to lower than expected underwriting revenue, A&O payments have consistently fallen below actual delivery expenses. Consequently, industry net income—comprised of underwriting gains and A&O payments less

delivery expenses—has averaged -1.9 percent of the industry retained premium over the three-year period of 2011-2013.

Headwinds

Notwithstanding "Tipping Points" and the challenges and opportunities of implementing the 2014 Farm Bill, the industry also faces some strong headwinds as we look to the future. Here is my short list:

Lower Commodity Prices

During the course of 2013, we have experienced a dramatic decline in crop prices, particularly in the corn and soybean markets. This is in contrast to the near doubling of crop prices occurring from the mid-2000s to 2012. The slow growth in the global economy, including in Europe, China and many emerging market economies, strong grain and oilseed competitors in export markets, the enduring productivity of the American farmer and the cessation of the previously strong growth in the amount of corn being demanded for ethanol production have all played a role in this downturn. The sharp price drop is also reflected in lower Net Farm Income (NFI). Based on USDA estimates, NFI for U.S. agriculture in 2014 is estimated to be 14 percent below the level in 2013 and the lowest since 2010. Still, 2014's NFI is expected to be the fifth highest ever. Part of that residual strength comes from very strong livestock returns, which mask somewhat the much lower crop returns expected in the Corn Belt, Plains States and Mississippi Portal region.

With lower crop prices, the value of the "assets" the insurance industry insures has declined. The reduction in NFI has resulted in farmers having less operating capital and they may consider reducing their crop insurance coverage. Fortunately, farm balance sheets are in pretty good shape; however, many farms locked into high cash rents are likely to experience financial stress. The near term agriculture economy should be considered a headwind.

Federal Budget Pressure

Suffice it to say, future funding for any Federal program will face strong headwinds, and crop insurance will surely continue to be buffeted by these same headwinds. For the past several years, the Administration's budget called for further reductions in funding for private delivery. Although the budget proposal was not adopted, it specifically called for significant reductions in delivery expense payments to the industry and reductions in risk-sharing revenue—in turn, further narrowing the rate of return to the industry—a prime example of reducing economic viability and shortening a leg of the stool.

It is also worth pointing out that the 2014 President's budget called for reductions in farmer premium discounts. These proposed reductions would raise the effective price of insurance and result in less affordable coverage—weakening another leg of the stool. There should be little doubt that future appropriations proceedings will call for reductions in outlays for both delivery system infrastructure and farmer premium support. Taken together, such reductions threaten affordability and viability of crop insurance and ultimately threaten availability.

Misinformation and Public Perception

Lastly, our industry continues to face the prevailing headwinds of misinformation and efforts to misdirect public perception. Opponents of a risk management-based farm safety net continue to paint crop insurance in a negative light. This negative light is likely to shine even brighter as debate continues in a post-2014 Farm Bill environment because direct payments—a longtime lightning rod of opponents' criticism—were repealed, leaving crop insurance to absorb the brunt of future attacks.

So be it. Fortunately, common sense has prevailed thus far. A national public opinion survey commissioned by NCIS immediately following the Farm Bill's completion showed that the critics' main messages have largely fallen flat. Farmers' favorability rating with the general public remains very high, and American's support farm policy and recognize its importance to the country. Furthermore, when they learned of the details of the 2014 Farm Bill, respondents agreed that crop insurance was a smart policy for the future.

Of course, the future of crop insurance and the risk management-based safety net as a whole will largely depend on the viability of private sector delivery. This means that industry, farmers, and lawmakers alike must remain vigilant to defend existing funding sources, promote an actuarially sound program, minimize regulatory burden, protect program integrity, and fend off baseless attacks on Capitol Hill and in the court of public opinion.

"Where to Now St. Peter?"

The question still stands, "*…Where to now St. Peter?*" The viability of the private sector delivery system will depend upon a host of economic and political factors, many of which are beyond the control of the industry or any individual company. Economically, a string of bad weather years or poor actuarial performance can shape future viability and participating companies may be forced to consider alternative deployment of their shareholder's capital. Politically, it is imperative that policymakers and crop insurance stakeholders remain committed to crop insurance and the farm safety net. For more than 30 years, the private sector has been fully committed to providing the best risk management tools to America's farmers and ranchers. And by working with our Federal partners we have seen crop insurance become the lynch-pin of the farm safety net.

This concludes our series highlighting the *Availability*, *Affordability*, and *Viability* of the Federal Crop Insurance program. I believe each of these conditions, or legs of the stool, are interdependent and critical for the future success of the farm safety net. Availability and affordability work in tandem. With both wide-scale availability and affordable premium, we have greater participation, greater risk-sharing and the demand for *ad hoc* disaster programs is reduced. As highlighted in this article, I believe viability of the private sector is essential to the successful delivery of the farm safety net envisioned in the 2014 Farm Bill.

Crop insurance is the practical, common sense solution for the farm safety net, and we all benefit from a financially healthy and stable farm sector.

In this issue of *TODAY*®, we take a look back at the 14 NCIS summer schools and field days. More than 1,200 loss adjusters attended our schools this year and studied simulated damage on more than a dozen crops. The success of our schools would not be possible without the leadership of the NCIS Regional/State Committees who sponsor the schools and the more than 180 plot leaders who took the time to help guide and teach the attendees. Your efforts are greatly appreciated. Also in this issue is an in-depth look at some of the new herbicides available to farmers authored by Dr. James Houx from NCIS. James explains the pros and cons of these new treatment options and encourages all insurance adjusters to be aware of these developments in crop protection. We also introduce you to the two new NCIS 1890s scholarship recipients—Anissa Taylor, a junior at Alabama A&M University majoring in food science and Jacinda Ruby Lugo, a junior at Fort Valley State University (Georgia) majoring in veterinary technology. We hope you enjoy all that the magazine has to offer this issue and we wish you all a very happy holiday season!