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Office of Inspector General

Risk Management Agency Activities to Renegotiate the Standard Reinsurance Agreement

Audit Report 05601-5-KC
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Office of Inspector General
Washington, D.C. 20250

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REPLY TO
ATTN OF: 05601-5-KC

TO: William J. Murphy
Administrator
Risk Management Agency

ATTN: Michael Hand
Deputy Administrator
Risk Compliance

FROM: Gil H. Harden /s/
Assistant Inspector General
for Audit

SUBJECT: RMA Activities to Renegotiate the Standard Reinsurance Agreement

Summary

Federal crop insurance is part of an overall safety net of Federal programs and includes protection for agricultural producers against financial losses caused by droughts, floods, or other natural disasters and against the risk of crop price fluctuations. The U.S. Department of Agriculture's (USDA) Risk Management Agency (RMA) has overall responsibility for overseeing delivery and administration of the Federal crop insurance program. Each approved insurance provider (AIP)[1] approved to sell and service Federal crop insurance policies must enter into a formal agreement with RMA, referred to as the Standard Reinsurance Agreement (SRA). Each agreement establishes the terms and conditions under which the Federal Crop Insurance Corporation (FCIC)[2] will provide subsidies and reinsurance on eligible crop insurance contracts sold or reinsured by the AIP.

In accordance with authority provided by the *Food, Conservation, and Energy Act of 2008, P.L. 110-246*, RMA established a timetable and initiated efforts to renegotiate provisions included in the SRA effective for the 2011 reinsurance year. RMA released two draft versions of the renegotiated SRA (December 4, 2009, and February 23, 2010), subject to comment by the AIPs

[1] A legal entity, including the Company, which has entered into a Standard Reinsurance Agreement with FCIC for the applicable reinsurance year.

[2] A Government-owned corporation that takes actions necessary to improve the actuarial soundness of Federal multiperil crop insurance coverage, and apply the system to all insured producers in a fair and consistent manner.

and other interested parties. The final SRA, with applicable appendices, was released on June 10, 2010.[3]

Program integrity continues to be identified as a significant challenge within USDA. The Office of Inspector General's strategic goal is to increase the efficiency and effectiveness with which USDA manages and employs public assets and resources, including physical and information resources. We initiated this review to identify and assess whether critical issues we have previously identified were being considered by RMA during the SRA renegotiation process. We identified and analyzed internal control weaknesses addressed in prior audits, as well as those identified by the AIPs.

During our review of the SRA renegotiation process, we provided RMA officials with written comments on provisions included in draft versions of the SRA. On January 19, 2010, and April 2, 2010, we provided comments on issues that we considered pertinent to the content of the draft SRA and the renegotiation process. We confirmed that some of our comments for FCIC proposals were considered or incorporated into the final SRA, while several other comments which expressed support for FCIC proposals were not. While the SRA renegotiation process for the 2011 reinsurance year is complete, we consider a number of these comments and issues pertinent to future renegotiations of the SRA.

Background

FCIC is a Government-owned corporation that was created on February 16, 1938, to promote the national welfare by improving the economic stability of agriculture through a sound system of crop insurance. An appointed Board of Directors provides overall guidance to FCIC. RMA is responsible for the supervision of FCIC and the administration and oversight of the Federal Crop Insurance Program. RMA was created as an independent office with passage of the *Federal Agriculture Improvement and Reform Act of 1996*, dated April 4, 1996.

In 1980, Congress enacted legislation that expanded the Federal Crop Insurance Program and directed that crop insurance (to the maximum extent possible) be offered through AIPs. AIPs offer various types of crop insurance policies, share the risk, and market Federal crop insurance. By regulation, each AIP and its managing general agent,[4] if applicable, must be in good financial standing and in compliance with the laws of the State where it is domiciled and in the States where its business is written. AIPs must be approved by RMA to participate in the crop insurance program.

Federal crop insurance is available to producers solely through AIPs that market, provide full service, and process claims for loss on, crop insurance policies upon which these companies share the risk. The SRA sets forth the terms and conditions under which FCIC will provide subsidy and reinsurance on eligible crop insurance contracts sold by AIPs. Essentially, AIPs insure producers and their crops and RMA subsidizes the producer's crop insurance premiums and reinsures the AIPs and reimburses them for administrative and operating expenses (A&O

[3] As of July 12, 2010, RMA received signed 2011 SRAs from all 16 AIPs that participated in the Federal crop insurance program during the 2010 crop year, formally ending the negotiation process which has been underway since December 2009.

[4] An entity that meets the definition of managing general agent under the laws of the State in which such entity is incorporated and in every other State in which it operates, or in the absence of such State law or regulation, meets the definition of a managing general agent or agency in the National Association of Insurance Commissioners Managing General Agents Act, or a successor Act.

Subsidy). The SRA is authorized by the Federal Crop Insurance Act and regulations contained in Title 7 of the *Code of Federal Regulations*, Chapter IV. *The Food, Conservation, and Energy Act of 2008* [P.L. 110-246] authorized USDA to renegotiate the SRA once every 5 years, starting with the 2011 reinsurance year. The prior SRA has been in effect since 2004.

For crop year[5] 2009, crop insurance coverage increased to 264 million acres, with a total Government insurance liability in excess of $79 billion. Indemnity payments for the 2009 crop year totaled over $5 billion, while the Government's subsidized share of the insurance premium totaled over $5 billion. For the 2009 reinsurance year,[6] 17 AIPs were authorized to sell and service crop insurance policies through a nationwide network of crop insurance agents and loss adjusters. Also, 2009 program records showed that AIPs serviced about 1.17 million policies.

First Draft of the SRA

The Food, Conservation, and Energy Act of 2008 authorized RMA to renegotiate the SRA, effective for the 2011 reinsurance year. In preparation for renegotiation of the SRA, RMA contracted with an internationally known company to review historical rates of return and determine a reasonable rate of return for the crop insurance industry. The contracted analysis showed that over the past 21 years, crop insurance companies averaged a 17 percent return, whereas a reasonable rate of return was 12.7 percent for general casualty insurance companies. In implementing the renegotiation process, USDA focused on six objectives for the SRA:

1. Maintain producer access to critical risk management tools.
2. Align A&O subsidy[7] paid to AIPs closer to actual delivery costs.
3. Provide a reasonable rate of return to insurance companies.
4. Protect producers from higher costs, while equalizing reinsurance performance across States to more effectively reach underserved producers, commodities, and areas.
5. Simplify provisions to make the SRA more understandable and transparent.
6. Enhance program integrity.

On December 4, 2009, RMA released its initial draft of the proposed SRA for the 2011 reinsurance year, along with three appendices to the agreement: Appendix I – Regulatory Provisions, Appendix II – Plan of Operations, and Appendix IV – Standards and Control. A corrected version of the initial draft of the SRA was released on December 7, 2009, and on December 22, 2009, RMA released an updated draft of Appendix III – Handbook Index. The deadline for submitting comments on draft provisions of the SRA and related appendices was January 15, 2010.

Second Draft of the SRA

On February 23, 2010, RMA released a second draft of the proposed SRA, along with Appendices I, II, III, and IV. In releasing the second draft, RMA stated that it had "carefully

[5] Crop year refers to the period within which the insured crop is normally grown, regardless of whether or not it is actually grown, and designated by the calendar year in which the insured crop is normally harvested, unless otherwise specified in the Crop Provisions.

[6] Reinsurance year means the term of this Agreement beginning July 1 and ending on June 30 of the following year and, for reference purposes, identified by reference to the year containing June.

[7] A payment made on behalf of producers to AIPs to cover the cost of selling and servicing the policy.

considered comments and recommendations from all AIPs and others." RMA further reported that "the second SRA draft incorporates many suggestions derived from these comments, while complying with the 2008 Farm Bill's directive to effectively address the significant rise in Government expenditures and ensure the continued strength of the Federal crop insurance delivery system." [8]

The release also highlighted some of the more important changes to the revised SRA draft, which included:

- Incorporate a 2-year transition period for companies to fully adjust to the new A&O subsidy structure. During the transition period, reference prices[9] will be 10 percent higher in 2011 and 5 percent higher in 2012; until base reference prices are reached for 2013.
- Provide for 5 percent higher reference prices for lesser served States.
- Limit initial company commitments for acquisition costs (that is, agent commissions) to 80 percent of A&O subsidy per policy, allowing for the use of profit sharing above this limit.
- Establish a nationwide Residual Fund[10] for each AIP, instead of a national fund in which all AIPs participate.
- Restructure and reduce the number of State groups from four to three; establish a separate group for underserved and lesser-served States.
- Revise the Commercial Fund[11] terms to be more generous in terms of profit potential for the 5 States included in Group 1; establishing improved reinsurance terms for the other 45 States.
- Decrease the Net Book Quota Share[12] from 10 percent to 7.5 percent, with 2.5 percent to be distributed to those AIPs that sell and service policyholders in the 17 underserved or lesser served States.

[8] SRA Second Draft Fact Sheet, RMA, dated February 17, 2010.

[9] Proposed commodities prices to be used for purposes of calculating A&O subsidy paid to AIPs; prices based on 10-year season average prices maintained by the National Agricultural Statistics Service.

[10] A proposed fund of AIP-designated crop insurance contracts in which the AIPs would retain a 50-percent interest in premiums and associated ultimate net losses.

[11] A State specific category of AIP-designated crop insurance contracts in which the AIP retains a 35-percent interest in premiums and associated ultimate net losses.

[12] A percentage of AIP cumulative underwriting gain or loss ceded to FCIC.

Final SRA

On June 30, 2010, RMA released the final SRA, announcing $6 billion in savings created through this action. RMA set forth that $4 billion of the created savings will go toward paying down the Federal deficit; the remaining $2 billion will support high priority risk management and conservation programs. RMA further set forth that "by containing program costs, these changes will also ensure the sustainability of the crop insurance program for America's farmers and ranchers for years to come." [13]

RMA highlighted the following provisions of the final SRA:

- Allows A&O subsidies to fluctuate within a range that removes extremes, thus preventing windfalls created by price spikes, yet ensures an adequate A&O subsidy provided to companies.
- Calculates A&O subsidy based on projected market prices, rather than reference prices.
- Provides a maximum A&O subsidy of $1.3 billion in 2011, with yearly increases based on inflation up to $1.37 billion in 2015.
- Limits company expenditures on agent commissions to 80 percent of the A&O subsidy, with allowed use of profit sharing. Total agent compensation limited to 100 percent of the A&O subsidy.
- Rebalances the risk sharing terms to equalize expected returns throughout the different States, including a return to the Assigned Risk Fund.[14]
- Provides an expected return to companies of about 14.5 percent.
- Sets the Net Book Quota Share at 6.5 percent, with 1.5 percentage points of any underwriting gain to be distributed to those AIPs that sell and service policyholders in the 17 underserved or lesser served States.

Objective

The primary objective was to monitor activities associated with the renegotiation of the SRA and provide suggestions or clarification for RMA's consideration for inclusion in the renegotiated SRA.

Result: RMA Completes Renegotiation of the Standard Reinsurance Agreement

On January 19, 2010, and April 2, 2010, we provided RMA officials with memorandums providing our comments for their consideration during the SRA renegotiation process. Some of our comments represented proposed changes to provisions of the draft SRA, while other comments set forth our support for FCIC proposals in the draft SRA. Our review of the final SRA and associated appendices indicated that RMA did take action to address some of our comments and that some of the FCIC proposals we supported remained in place. Examples of

[13] USDA news release No. 0316.10, dated June 6, 2010.

[14] A State specific fund of AIP designated crop insurance contracts in which the AIP retains a 20 percent interest in premiums and associated ultimate net losses.

Office of Inspector General (OIG's) suggestions followed by RMA's final actions are described below.

- OIG supported the FCIC proposed reduction in the number of insurance funds (i.e., elimination of the three Developmental Funds[15] and consolidation of the three Commercial Funds[16] into one fund). The final SRA eliminated the Developmental Funds and consolidated the Commercial Fund.
- OIG supported the FCIC proposal to limit agent commissions to 80 percent of the A&O subsidy. The final SRA retained the 80 percent limit (of the A&O subsidy) for agent commissions while allowing additional distributions of profit sharing, limiting total agent compensation to 100 percent of the A&O subsidy.
- OIG suggested that FCIC clarify the criteria and methodology for the proposed disbursement of any net underwriting gain from the Net Book Quota Share to AIPs. The final SRA provided the formula by which RMA will determine the amount of disbursement of any net underwriting gains.
- OIG identified a number of instances where we suggested that FCIC replace subjective wording with more definitive word choices. The final SRA replaced most of the identified subjective wording with more definitive alternatives offered by OIG.
- OIG supported the FCIC proposal to eliminate the establishment of minimum training hour requirements for agents and loss adjusters as set forth in Appendix IV, in favor of requiring agents and loss adjusters to take and pass a proficiency test developed by the AIPs and approved by RMA. The final Appendix IV to the SRA reincorporated minimum training hour requirements for agents and loss adjusters, but retained the requirement for agents and loss adjusters to pass a proficiency test.

Several of OIG's comments were not incorporated into the final draft of the SRA, and some of the FCIC proposals that we supported were subsequently revised or eliminated. While we understand that the SRA is an agreement between FCIC and the AIPs, we still consider the following to be valid issues and concerns worthy of consideration in future renegotiations:

- OIG suggested that FCIC revise the definition of "satisfactory performance record " to eliminate subjective references and establish measurable criteria by which performance can be evaluated as satisfactory vs. unsatisfactory. The final SRA contained the same definition as set forth in draft versions of the agreement.
- OIG supported the initial FCIC proposal to establish a Residual Fund (replacing the Assigned Risk Fund provided for in the prior SRA) in which all AIPs would participate, and to establish the retention[17] of premium and ultimate net losses[18] as a percentage share

[15] A group of three sub-funds, provided for in the prior SRA, in which AIPs retained a 35 percent interest in net book premiums and associated liabilities for ultimate net losses on eligible crop insurance policies designated to each of the sub-funds in each State.

[16] A group of three sub-funds, provided for in the prior SRA, in which AIPs retained a 50 percent interest in net book premiums and associated liabilities for ultimate net losses on eligible crop insurance policies designated to each of the sub-funds in each State.

[17] The retention interest means the remaining liability for ultimate net losses and the right to associated net book premiums after all reinsurance ceded to FCIC under this Agreement.

[18] The amount paid by the AIP in settlement of any claim and in satisfaction of any judgment, arbitration award, or mediation (including any applicable interest), less any recovery or salvage by the AIP.

of total net book premium[19] for all funds and AIPs. We also supported the subsequent FCIC proposal, which modified the Residual Fund by making it AIP specific and requiring each AIP to retain a 50 percent interest in premiums and ultimate net losses. The final SRA returned the fund designation to the Assigned Risk Fund, established the fund as being Company and State specific, and reduced the AIP retention interest in premiums and ultimate net losses from 50 percent to 20 percent.

- OIG supported the FCIC proposal to index the payment of A&O subsidies using established reference prices for insurable commodities. The final SRA eliminated the proposed use of reference prices for indexing the payment of A&O subsidies, returning to a payment system similar to the one set forth in the prior SRA.
- OIG suggested that FCIC revise Appendix IV to reinstate previously set forth sections detailing associated FCIC responsibilities; thus providing clear disclosure of the responsibilities for all parties subject to the agreement. The final Appendix IV did not include any discussion of FCIC responsibilities.

We are not making any recommendations within this report and no further action or response to us is required.

Scope and Methodology

The review focused on development of the draft and final SRA and associated appendices, effective for the 2011 reinsurance year. The review included assessments of the draft and final SRA provisions, taking into consideration previously raised issues and recommendations set forth in prior and pending OIG audit reports, as well as the previous OIG evaluation of the prior SRA negotiation. Based on these assessments, OIG provided RMA with written comments for its consideration in development of the final SRA.

We performed our audit fieldwork between October 2009 and June 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We appreciate the courtesies and cooperation extended to us by your respective staffs.

[19] The premium amount established by FCIC for eligible crop insurance contracts less any amount for A&O subsidy.

Informational copies of this report have been distributed to:

Administrator, RMA
Attn: Agency Liaison Officer (3)

Government Accountability Office (1)

Office of Management and Budget (1)

Office of the Chief Financial Officer
Director, Planning and Accountability Division (1)