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BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON
GENERAL FARM COMMODITIES AND RISK MANAGEMENT

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Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to join Administrator Gould today to report on the status of the Federal crop insurance program. My comments today are from the perspective of the Board of Directors (Board) of the Federal Crop Insurance Corporation, which I chair. The Board has general management responsibility for the Federal Crop Insurance Corporation (FCIC).

At the outset, I would like to acknowledge the outstanding efforts and accomplishments of the FCIC Board. In addition to myself, current voting Board members include J.B. Penn, Under Secretary for Farm and Foreign Agricultural Services; John Askew, a producer from Iowa; Frank Jones, a producer from Texas; Tim Kelleher, a producer from California; Luis Monterde, a producer from Mississippi; Bill Classen; a resident of Iowa with expertise in the insurance industry; and Mike Pickens, an attorney from Arkansas with expertise in insurance regulation. Risk Management Agency (RMA) Administrator Eldon Gould is Manager of FCIC and a nonvoting member of the Board. The Board also greatly benefits from the assistance of Floyd Gaibler, Deputy Under Secretary for Farm and Foreign Agricultural Services, and Brent Doane, Secretary to the Board.

Since the Agricultural Risk Protection Act (ARPA) was signed into law in mid 2000, the Federal crop insurance program has undergone a number of changes that have made crop insurance more popular with producers and a more reliable and versatile risk management tool. In 2000, prior to ARPA, participation in the program was high based on acreage covered, but producers generally had low levels of coverage, with many insured at the catastrophic (CAT) level, which indemnifies only 27.5 percent of the value of production in the event of a total loss. CAT coverage is minimal and many producers need more coverage to permit financial recovery in the event of a major loss. In addition to low coverage levels, farmers in the Northern Plains had suffered multiple year crop losses, which reduced their guarantees for the next year, which are based on their actual production history (APH yield). The 1998 drought in Texas and the Southeast and subsequent natural disasters triggered repeated ad hoc disaster assistance programs in 1998, 1999, and 2000. Thus, an important goal of ARPA was to address low coverage levels and improve programs generally to obviate the need for ad hoc disaster assistance. With tools provided by ARPA, the RMA and the Board have worked together to build a stronger, more effective crop insurance program. While we believe the program has been significantly strengthened, a perceived need for ad hoc disaster assistance has not yet been eliminated.

Key Parameters Established by ARPA

ARPA reforms included increased premium subsidies for all levels of coverage, making crop insurance more affordable for farmers and encouraging higher participation and coverage levels. ARPA also authorized coverage for livestock on a pilot basis. ARPA streamlined the process that encouraged private sector development of new products by clarifying and placing time limits on product approval and by allowing developers of successfully approved products to be reimbursed for their research and development costs. ARPA also emphasized new ways to control fraud, waste, and abuse.

Crop Insurance Today

For the 2005 crop year, there were 1.2 million Federal crop insurance policies in force with a liability of over $44 billion covering 246 million acres and 320 commodities. This compares with 1.3 million policies with a total liability of $34 billion covering 206 million acres for the 2000 crop year, just prior to enactment of ARPA.

While we have seen expected growth in insured liability for the big row crops since 2000, we have also seen an increase in coverage for many specialty crops. Insurance products that offer whole farm or revenue protection have also shown growth, with the Revenue Assurance plan leading the way by increasing total liability from under $700 million in 2000, to $13.5 billion in 2004. Compared with the 2000-crop year liability level, Group Risk Income Protection (GRIP) has increased tenfold in liability and the Adjusted Gross Income (AGR) plan of insurance has increased by over 30-fold.

Since the increase in premium subsidies under ARPA, more farmers are buying levels of coverage above CAT. In 2000, CAT coverage accounted for 21 percent of the program's total liability. In 2005, 16 percent of liability was at the CAT level. Buy-up levels of insurance increase the possibility of financial recovery following a severe crop loss for most farmers. Some producers may find that CAT or similar low coverage levels offer an optimum level of coverage for their business, such as producers having crop income that is only a small part of their farm income, facing very infrequent losses due to natural disasters, having sufficient assets to self insure, or being able to take proactive measures to reduce natural disaster risks. However, for most producers, buying policies with increased buy-up coverage appear to be necessary to allow them to move away from reliance on Government disaster assistance and be able to accept greater responsibility for managing the risks they face.

The actuarial performance of Federal crop insurance has steadily improved over the years. During l981-1990, the loss ratio, which is total indemnities divided by premiums, averaged 1.53. During the 1991-2000, the loss ratio declined to an average of 1.07. And during 2001-2005, with 2005 being an estimate, the loss ratio has averaged an even lower 0.93. Over time, premium rates have increased to cover expected losses. Part of the increase in premium rates was due to the assessment of historical experience and establishment of target rates by RMA to better cover expected losses, and part of the increase was due to changes in the types of policies purchased by producers, including more buy-up coverage. The increase in premium subsidies under ARPA also increased participation, drawing more low risk producers into the program, thereby reducing adverse selection and improving actuarial performance.

An important principle for the Board is, "USDA does not sell a single crop insurance policy." Federal crop insurance is entirely delivered to producers by private insurance companies (companies). Over time, some companies have exited the business, others have merged or been acquired, and new entrants have joined the program. The Board and RMA serve as regulators of this private sector delivery structure, which must be efficient and financially healthy if the Federal crop insurance program is to succeed. Today, RMA has a Standard Reinsurance Agreement (SRA) with the 16 companies that constitute the public-private partnership for the delivery of Federal crop insurance. The SRA defines the risk sharing agreement between the government and the companies that is crucial to the efficient operation of the program. By being able to share in the underwriting gains, companies have an incentive to participate in the program and expand sales, and by sharing in the losses, they have an incentive to ensure policies are properly underwritten and loss adjusted.

The SRA also establishes the reimbursement to the companies for administrative and operating (A&O) expenses in accordance with the provisions of the Federal Crop Insurance Act (Act). For the 2006 reinsurance year, the rate at which we reimburse the companies' A&O costs has changed compared with earlier years. In 2000, the average reimbursement rate was 25.7 percent of net premium. In 2005, the average was 21.8 percent of net premium, and for the 2006-crop year, the average reimbursement is 20.7 percent.

For the 2005 insurance year, A&O reimbursements are estimated at $830 million, up from $550 million in 2000. Despite the decline in the A&O reimbursement percentage, the total dollar reimbursement is up because of the increase in premium per policy, primarily due to higher average coverage levels, greater purchase of revenue insurance, and RMA rate adjustments. Underwriting gains for the companies are up as well, rising from $270 million in 2000 to $870 million estimated for 2005. The combined increases in A&O and underwriting gains have helped improve the financial performance of the companies and encouraged new entrants into the program. Having highlighted the large increases in companies' gross returns, it should be noted that a major national weather catastrophe could lead to very large underwriting losses in any year.

One of ARPA's significant provisions was reform of the development and approval process for new insurance products. In the mid 1990s, when companies introduced new products, such as Crop Revenue Coverage and Revenue Assurance, they shouldered the research and development costs, and their products were immediately adopted by their competitors without compensation. Section 522(b) of the Act provided that private entities may be reimbursed for research and development and maintenance costs for four years if the product is submitted under Section 508(h) of the Act (508(h) products) and approved by the Board for use in the Federal crop insurance program. A total of 59 proposals have been submitted to the Board under Section 508(h) of the Act since mid 2000. Of that total, 33 have been approved by the Board, 7 have been disapproved or a notice of intent to disapprove has been issued, 13 were withdrawn by the submitter, 4 were returned or deemed incomplete, and 2 have been tabled pending further action. Approved 508(h) products range from a hybrid seed price endorsement to livestock price and revenue products to AGR-Lite.

Board Activities and Priorities

Management of the FCIC is vested in a Board of Directors subject to the general supervision of the Secretary of Agriculture. Board members take actions necessary to protect the interests of producers, improve the actuarial soundness of the program, and apply program provisions to all companies and insured producers in a fair and consistent manner.

The Board carries out its business through public meetings held 8-10 times per year and other working sessions among its members. The Board has executed a detailed division of responsibilities between itself and RMA. With respect to those functions delegated to RMA, the Board regularly reviews RMA's performance. The Board also establishes the priority for RMA efforts to improve the operation of Federal crop insurance.

A high priority of the Board has been to work with RMA to deal with a large backlog of pilot programs that must be evaluated and then modified and continued, approved for permanent programs, or terminated. Many of these programs were initiated in the late 1990s to address perceived areas of insufficient insurance coverage, or they were authorized by ARPA. RMA currently administers 26 pilot programs for the 2006 crop year. Because pilot programs are new, they must be continually monitored to ensure acceptable performance, and if they are not, immediate corrections must be made. After a period of 3-5 years, a thorough evaluation is conducted on each pilot program and the results of the evaluation are brought to the Board for action. Of the pilots initiated in the late 1990s or under ARPA, the Board has voted to terminate four programs, extend two programs to gain additional experience, and make five pilot programs permanent. In addition, the Board has revised and made available three new programs. There are final evaluations under way on eight pilot programs upon which the Board expects to make decisions within the next two years. Generally, the process of going from an idea to a permanent program takes many years for an FCIC-originated product. As a result of the limitations on RMA to conduct research and development contained in the Act, the process includes a contracted feasibility study, a contracted policy development study, 3-5 years of piloting the program, a contracted evaluation study, and conversion to a permanent policy through notice and comment rulemaking.

One difficult example the Board dealt with was the sweet potato pilot program. It began in 1998 in eight counties to assist growers with a crop requiring high capital investment and operating expenses combined with limited margins. Loss ratios were unacceptably high, indicating rating, underwriting and loss adjustment problems, so the Board approved a series of changes with the 2003-crop year and asked RMA to contract to develop a new sweet potato crop insurance pilot. A revised sweet potato pilot came before the Board in July 2004, and after review, the Board terminated the existing sweet potato pilot program in October 2004 and implemented the newly developed pilot.

In deciding the fate of a pilot program, as for any decision the Board makes, the Board considers whether its actions are in the interests of producers and the crop insurance program, whether such action can be implemented in an actuarially sound manner, and whether program integrity will be protected. A recent complex issue for the Board and RMA is the Florida Fruit Tree Program. The Board voted last fall to implement numerous program improvements for 2006 for the existing pilot program, which was not working well for Florida citrus producers. The changes included an occurrence loss option and an option for comprehensive tree value, which covers the lost asset value of destroyed trees. While the policy provided coverage for losses due to citrus canker, indemnification was predicated on an eradication order and the destruction of the trees, which was required if citrus canker was discovered.

However, following last fall's hurricanes, the spreading of citrus canker changed the assessment of expected losses on which the premium rate structure of the policy was calculated. In addition, the policy of requiring the destruction of the trees is now changing, and we have found it necessary to modify the policy again. The Board has met with citrus canker experts and RMA has been working closely with other USDA agencies to monitor the changing approach to controlling citrus canker in the state of Florida. As a result, the Board has authorized RMA to move forward with policy modifications that will provide new policy features for losses that are not related to citrus canker but still offer coverage for citrus canker in a responsive and prudent manner considering changes in the citrus canker program. The details of the new policy are still being developed.

Another issue of concern to the Board is implementation and maintenance cost for insurance products that do not sell well and thus offer limited benefits to the producer. The Board has requested additional information on potential sales and costs from submitters before considering a product for approval and from RMA before taking action on pilot program evaluation. The Board considers whether the product could be better structured to meet the needs of producers and looks closely at the cost of research and development, the cost of maintenance, and the administrative complexity of a program. High costs to USDA and the companies, which include agent training costs, relative to policies sold has been a factor in the Board's determination of whether approval is in the best interest of producers. When rejecting a product or terminating a pilot program, the Board also considers alternative risk management tools available to the producers, including the availability of other products, such as AGR and AGR-Lite, which cover all of the farm's income from production. The Board is hopeful that continual improvements in AGR and AGR-Lite will be part of the answer to the rising expense of administering a large number of crop-specific programs that generate a low level of sales.

In November 2005, the Board voted to adopt improvements in AGR and AGR-Lite. The 2004 and 2005 crop years saw little change in the participation levels of AGR with both years having around $300 million in liability. AGR-Lite increased from $3 million to $13.4 million in liability between 2004 and 2005. Recent Board actions taken on AGR and AGR-Lite include reducing the number of commodities required for higher coverage levels and discontinuing the 75 percent coverage level/65 percent payment rate option. AGR and AGR-Lite may become a valuable risk management tool especially for diverse farms and livestock operations. However, these are complex policies that require considerable agent time and expertise to service and sell. The Board has been interested in simplifying these policies but has found that task difficult to this point.

There are areas where simplification is proceeding. For example, the Board worked with RMA to initiate development of a proposed rule combining a number of existing APH and revenue insurance plans into one consolidated plan of insurance. The producer will be able to choose a yield-based or revenue-based product from the options in the combined policy according to individual needs.

There has historically been a key gap in insurance coverage of livestock. ARPA authorized pilot programs to evaluate effectiveness of risk management tools for livestock producers with an annual spending limit of $20 million. The first livestock pilot was offered in 2003 for swine in Iowa. We now have Livestock Risk Protection (LRP), which covers hog, fed cattle, and feeder cattle prices, and Livestock Gross Margin (LGM), which has covered the margin between hog prices and feed costs. LGM is being extended to fed and feeder cattle in 2006. In the 2005 crop year, the FCIC insured over 540,000 hogs under the LGM program with a liability of $51 million. The LRP program for 2005 insured over a quarter million head of livestock with a liability of $104 million. Both programs had very low loss ratios. Recently, the Board and the submitter of a LRP pilot program for lamb agreed to table consideration of this pilot to permit academic and industry experts to evaluate the concept of econometric modeling as a basis for establishing an insurance guarantee for those commodities for which there is no established market that permit price discovery. This study could affect not only the proposed LRP Lamb Program but other products for which an established commodity market does not exist.

The Board made development of insurance products for pasture and rangeland a top priority for addressing the needs of livestock producers. There are over 400 million acres of rangeland, 120 million acres of pasture, and 62 million acres of hay in the United States. Because pasture, rangeland and forage situations are so diverse across the country, existing insurance products are limited in their usefulness. Existing products are based on an individual’s forage production or on NASS estimates of hay production. Working with RMA, in January, 2006, the Board culminated a several year process of development by approving two pasture, range, and forage pilot programs. The new insurance products are area based products that trigger indemnities based on indexes. One index is based on accumulated rainfall and the other is based on a temperature-adjusted measure of vegetation obtained from the National Oceanographic and Atmospheric Administration. Both products will use new technology to help solve the problem of the inability to directly measure forage production across the diverse range and pasture settings on U.S. farms and ranches. Each pilot program will be offered in 2006 in 6 states.

The issue of premium discounts has taken considerable Board time in the last few years. Section 508(e)(3) of the Act provides the opportunity for an insurance company in the program to offer a premium reduction plan (PRP). The Manager of the FCIC approved one company to offer PRP for the 2003 crop year, and you are aware of the controversy that ensued. Then, a larger number of companies applied to be eligible to offer the program, raising implementation issues. The Board determined that rulemaking was necessary to establish the application, approval, and payment process. A proposed rule was published, and based on the comments received, RMA elected to publish an interim rule to implement the PRP program. Congress subsequently prohibited RMA administrative expenses to be spent on considering applications to offer PRP for the 2007 insurance year. The Board continues to work with RMA to monitor PRP for the 2006-crop year.

The Board has also been involved in two significant contracted research efforts to address program concerns. One effort is to address the effects of declining yields on producers’ abilities to buy sufficient insurance coverage for the next year. Two separate development contracts are underway on potential solutions to declining APH yields due to successive years of crop losses. One contractor is developing an indexed yield approach for corn, cotton, soybeans, and wheat. Another contractor is developing alternatives to the current APH yield methods that limit the amount yields may drop for annual crops and analyzing applicability for perennial crops. A feasibility report and presentation is scheduled for RMA for May 2006.

Conclusion

Six years is not a long time in the world of crop insurance where long time series of data are needed to make sound decisions. Yet, much has been accomplished since ARPA was enacted. It has not, as hoped, prevented ad hoc disaster assistance and it has also not generated the volume of new product submission from the private sector that may have been envisioned. But, implementation of ARPA has significantly strengthened the risk protection tools available to producers and the actuarial performance of the program. As we look forward to a new Farm Bill and the next generation of farm programs, the need for risk management tools such as crop insurance will not lessen. The attractiveness of insuring an uncertain crop outcome is the certainty of the financial result for the insured producer. With adequate protection, farmers need not jeopardize their livelihood as a result of natural disasters. The FCIC Board will continue to diligently examine, encourage, and demand improvements in insurance products that are in the interest of producers, that are actuarially appropriate, and that protect the interests of the American taxpayer. That completes my comments.