

Agency: Federal Crop Insurance Corporation, U.S. Department of Agriculture

Docket ID No. FCIC-12-0007

Comments on Notice of Request for Approval of a New Information Collection

Submitted by National Crop Insurance Services (NCIS), Overland Park, KS

National Crop Insurance Services, Inc. (NCIS) appreciates the opportunity to comment on Notice of Request for Approval of a New Information Collection. In this notice, Risk Management Agency (RMA) announced its intention to request approval for a new information collection for Federal Crop Insurance Program Delivery Cost Survey and Interview and seek comments from industry as well as other stakeholders. RMA contracted with KPMG LLP (KPMG, <http://www.kpmg.com/US>, henceforth “contractor”) to conduct the interviews and survey, and carry out a study based on the information obtained from the survey. Contractor gave a presentation to industry on July 10, 2012 in a meeting hosted by contractor and RMA in Washington, DC. NCIS and Approved Insurance Providers (AIPs) did not attend the meeting in person, but joined the meeting through LiveMeeting instead. Contractor provided a copy of the presentation to NCIS following the meeting. The presentation is attached to this document and will be referenced throughout.

NCIS has reviewed the notice and contractor’s presentation and obtained AIP input. NCIS maintains the same concerns and comments as were stated in its response to Informational Memorandum IS-11-003 on May 6, 2011 (where RMA had requested preparatory input from industry as well as other stakeholders before soliciting contract proposals for a cost of delivery study). Nevertheless, NCIS provides comments to the notice and contractor’s presentation as follows.

This project has its origins in a GAO report (GAO-09-445) released in April 2009 (slide 16). The GAO report was prepared at the height of crop prices which resulted in an unanticipated increase in administrative and operating expense (A&O) payments. Since the time the GAO report was published, an upper limit was placed on A&O and agent compensation by the 2011 SRA, so that the potential for excessive A&O payments due to high crop prices is no longer a concern. The notice asks whether the proposed collection of information is necessary for the proper performance of the functions of RMA, including whether the information will have practical utility. It is not clear how RMA will use the information they seek. For example, the upper limit on A&O introduced in the 2011 SRA negotiations was not based on the informational input that could be obtained from the study that contractor intends to carry out. Furthermore, since RMA has no direct responsibility for how companies use the A&O they receive to deliver the program to eligible producers, it is difficult to understand how the information collected is necessary for the proper performance of the functions of RMA. Indeed,

(see p. 39989 in the notice, col. 2, the paragraph immediately under Interviews section), RMA admits that they currently do not understand the expenses AIPs incur in delivering the Federal crop insurance program. This raises the question of whether RMA plans on restructuring A&O depending on different factors such as geographical region, types of crop insurance sold, and number of insurance policies sold.

Contractor states their objective as estimating the economic costs of delivering the program rather than accounting costs. Contractor points out that what companies are currently spending might not reflect the underlying economic costs of delivery, and that failure to distinguish between actual costs and “true underlying costs” has been a problem with past studies (slide 17). The same point was made in RMA’s presentation at the 2012 annual meeting of Agricultural and Applied Economics association (Lanclos, 2012). This statement seems to imply a belief in the existence of a market failure of some sort, such that the organizations and individuals engaged in delivery are failing to control costs properly. If RMA believes that such a problem exists, and expects contractor to study it, that problem must first be addressed at a conceptual level within an analytical framework. The nature of the market failure first should be identified, and industry should have an opportunity to comment upon these findings. Without an understanding of the origin of such a problem, efforts to compute the “true underlying costs” of delivery are unlikely to be successful.

The difference between the economic cost (opportunity cost) versus accounting costs is basic in economics. At the same time, it is a difficult task to accurately measure the opportunity cost. Contractor’s presentation and the information in the notice do not provide assurance that this objective can be accomplished. Contractor’s proposal amounts to the detailed examination of the AIPs and agents’ reported expenses. Grant Thornton LLP currently uses information collected from survey of AIPs to prepare their “Federal Crop Insurance Program: Profitability and Effectiveness Analysis” report. In this report, Grant Thornton, LLP independently performs a benchmarking comparison of the profitability and cost of AIPs with the Property and Casualty (“P&C”) industry. Thus, with regard to AIPs cost of delivery, contractor appears to duplicate what Grant Thornton LLP has already been doing.

The issue of economic cost has already been addressed to some extent in the study conducted by Grant Thornton LLP. In terms of the underwriting profitability of the program, the

study finds that crop insurance markets are riskier relative to P&C industry, thus requiring higher rates of return (Grant Thornton, 2011) in recognition of the opportunity cost of capital.

Similarly, opportunity costs for agents should address the returns agents are able to obtain for an investment of their time in other lines of insurance. Unlike many lines of insurance, crop insurance is not a commodity business in which insured individuals are treated uniformly and provided with minimal levels of service. Contractor correctly identifies that selling and servicing the Federal crop insurance policies requires greater frequency of contacts between an insurance agent and the insured farmer relative to P&C. In the crop insurance program, cost is a function of the level and quality of service provided to farmers which is an outcome of market competition. Farmers currently benefit from the efficiency of processing claims and quality of service that comes with private sector delivery. Any evaluation of expenses should be related to the level of service provided in order to evaluate how differences in knowledge, skills, ability, and effort are reflected in the results. For example, some agents specialize in crop insurance and may spend a great deal of time involving themselves in many aspects of farmers' operations. Furthermore, any expense estimates developed by contractor should specify the level of service associated with the indicated cost. Ideally the study should provide information about the tradeoffs between the level of resources devoted to delivery and level of service provided by the delivery system. A better understanding of these tradeoffs could facilitate efforts to optimize the design of the program.

In light of these facts, RMA should consider clarifying the issues it hopes to address with this study and take a broader perspective beyond the recommendations in the GAO report three years ago. Rather than focusing solely on the expense of program delivery as a static concept, the study should recognize that cost is interlinked with the output/value produced and delivered by the program. The study should also evaluate whether the program operates efficiently and achieves effectively the objectives set for it by Congress. To this end, NCIS emphasizes that the major issues that the crop insurance program faces should be at the forefront in developing objectives for this study. These issues are (1) whether the incentive structure is designed in a way that encourages high participation for all states and commodities, (2) whether agents and companies are being adequately and competitively compensated for their efforts, (3) whether the incentive structure ensures that A&O is sufficient to cover all expenses (as compared to companies absorbing a portion of the cost), (4) whether the incentive mechanism has unintended

consequences including a shift in A&O between states as commodity prices change, and (4) identifying inefficiencies and program management decisions that contribute to the cost of delivering the program.

In the following, NCIS provides more specific points regarding the notice and contractor's presentation.

The study should avoid the use of arbitrary assumptions as this may bias the outcome. For example, the contractors' presentation included the assumption that expenses are equal to A&O reimbursements, though this assumption was subsequently withdrawn. If the study is to consider the possibility that the current level of spending on A&O is not the correct level of spending, it should be open to the possibility that current expenditures are insufficient either nationally or regionally. Current levels of expenditure may not support a level of service that will allow the program to achieve its goals. If the study is to consider the possibility that the current level of expenditure on program delivery is not optimal, it should not prejudice the nature of the discrepancy it is seeking to measure. Contractor should not attempt to evaluate the propriety of various expenses, as that would substitute contractor's judgment for the judgment of tax accountants and the IRS in determining reasonable and necessary business expenses. The scope of the study should evaluate at least an entire year's activity to account for peak workload issues and take year-to-year variability in the workload into account.

Contractor will interview AIPs, agent/agencies, and farmers to develop survey questions. Stakeholders should be provided the opportunity to review the resulting survey prior to sending it out to agents/agencies and farmers. RMA estimates that interviews with AIPs will take 2 hours per response, interviews with agents and farmers will take 1.5 hours per response, and survey of agents and farmers will take 0.5 hour per response. The estimate of 0.5 hour for survey response appears to be unrealistic considering the scope of questions to be asked (slide 29) and the overarching objective of measuring opportunity cost. Contractor states that approximately 12,400 insurance agents sold crop insurance in reinsurance year (RY) 2011 (slide 30). Although this number sounds reasonable, population size needs to be determined more precisely. Contractor states that they want to sample approximately 20% of agents (slide 30). They will sample 2,627 out of 12,400 agents (21% sampling ratio). Of the agents sampled, RMA estimates that 30% will respond (788 agents). The number of estimated respondents divided by the size of population of

agents equals 6%. RMA needs to disclose the targeted statistical precision level (margin of error) with the sampling ratio of 21% and response ratio of 30% with respect to the sample. Against the possibility of ineligible sample points or responses, the sampling ratio may need to be adjusted upward.

Contractor should decide on appropriate strata in the agent/agencies' survey. Within each stratum, contractor should strive to achieve the targeted sampling ratio so that the resulting sample can be representative of the population. Contractor plans to stratify the sample into six regions: Midwest, Plains, South, West, Mountain, and Northeast (slide 30). They should also stratify in terms of size of agent/agency (such as very small, small, and large according to reasonable criteria) and type of agent/agencies (such as captive or independent). As a result, contractor should have 36 stratum ($36 = 6 \times 3 \times 2$) in agents' survey. Contractor may consider systematic sampling over random sampling for certain strata or even taking a census if a certain stratum's sample size is inadequate. Furthermore, contractor needs to carry out a thorough non-response bias analysis. This would include performing statistical tests for the differences between respondents' and non-respondents' characteristics such as such as region, type and size.

Contractor states that the response rate is expected to be low (slide 33). Against this possibility, they ask for assistance from AIPs in the form of an awareness campaign, and rely on advance notification e-mail and reminder e-mail. NCIS recommends that a respondent within each agency must be identified through a telephone call. A reminder postcard or e-mail could also be useful. Follow up telephone calls to non-respondents may be needed. Contractor must have a well-thought out plan in handling survey data collection process to maximize the number of responses (see Cates et al. 2005 for an example).

According to information provided by RMA, there are 496,386 farmers with policies earning premium in 2011. RMA's Summary of Business indicates that the number of policies earning premium was 1,151,452 in 2011 crop year (a farmer can have more than one policy, or more than one farmer can be on a single policy). Contractor states that of the insured farmers, 20% of those associated with sampled agents will be sampled (slide 31). Dividing the number of insured farmers (496,386) by the number of agents (12,400) gives 40 insured farmers per agent. It appears that contractor will initially survey agents and then carry out a follow up survey of the farmers that are served by the agents who responded to the initial survey. Based on the estimate of responding agents, that yields a sub-population of approximately 31,545 insured farmers (

31,545=40×788). Of those 31,545 insured farmers, 20% will be sampled, which corresponds to 6,309 farmers. However, RMA estimates that 525 insured farmers will be sampled, and of those sampled, 158 insured farmers will respond (30% response rate with respect to the sample). The number of farmers that are expected to respond to the survey is less than 0.032% of the insured farmers population ($0.0318\% = \frac{158}{496,386} \times 100$) and 0.5% of farmers that are potentially served

by the agents who responded to the initial survey ($0.5\% = \frac{158}{31,545} \times 100$). As it stands, RMA's

estimate of sample size for the survey of farmers is insufficient. A representative sample of farmers is essential for the accuracy of information to be collected. Contractor states that surveying of insured farmers will be done to determine the level of services (e.g. number of insurance agent visits, educational services, and other services, telephone calls, mailing) necessary for farmers to make an informed decision. Contractor also states that data gathered from the survey of insured farmers will serve as a consistency check and will not be directly used to estimate the cost of delivery incurred by insurance agent (slide 29). It is not clear what criteria will be used to determine the inconsistency between responses of agents and farmers and what course of action will be taken if an inconsistency is found.

NCIS staff and industry representatives question the accuracy of the commissions estimates presented in slide 13, where only about \$900 million for commissions in RY 2011 are shown. Commissions are expected to be higher, perhaps close to 100% of A&O subsidy. This information needs to be reviewed and corrected, with the revised information provided to interested parties.

Contractor states that they will estimate insurance agent/agency costs by combining various sources of data (slide 27). Internal Revenue Service's (IRS) statement of income (SOI) data for insurance agents and brokerages will form the baseline percentage estimate of itemized expenses incurred by crop insurance agents. It is not clear whether the IRS data distinguishes between P&C agency expenses and life insurance and other market segments. In addition, the usefulness of this data can be questioned due to the variety of entity structures under which agencies are organized and how compensation to owners is handled. The year of information being used will also be important since agent compensation for the crop insurance program has been capped starting with 2011. Certain costs incurred by agents, such as travel and health care,

have increased rapidly, and a comparison to costs in earlier years may not be reliable. Agents will be surveyed to report the variations in percentage of expense over income relative to the SOI baseline estimates. Based on the latter information, Contractor proposes to adjust the baseline percentages to arrive at the applicable expense percentages for crop insurance industry (slide 28) but does not explain how this to be accomplished. Contractor will also compare the preceding estimates with the “Insurance Agents Data by State” and RMA’s Agent Commission/Compensation Data by State (slide 27). Contractor mentions wage data for insurance sales agents by state from Bureau of Labor Statistics (BLS) (slide 27) but does not explain how they will use this data. This may be relevant since agents can be paid via wages, commissions, or a combination of the two. Contractor also did not provide information on the statistical basis for their adjustments. It seems as if contractor plans to do some of sort of benchmarking analysis that does not appear to be based on any formal economic or econometric model.

The Federal Crop Insurance program is a dynamic, complex, and evolving program. Since enactment of the Federal Crop Insurance Act of 1980, it has become the centerpiece of the economic safety net for agricultural crops, protecting over \$113 billion worth of liability in 2011 alone (U.S. Department of Agriculture, 2012a). Indeed, government spending on crop insurance is projected to exceed all spending on farm commodity programs during fiscal years 2011 to 2020 (Congressional Budget Office, 2012). Some crop insurance products provide yield protection at the field, farm, and county levels and others provide revenue protection at the field, farm and county levels. During the life of 2008 Farm Bill, crop insurance interacted with other farm programs such as the ACRE (a state level insurance guarantee program) and SURE (the permanent disaster aid program) programs administered through Farm Services Agency (FSA) (U.S. Department of Agriculture, 2012a). For example, farmers were obligated to obtain crop insurance or protection under the non-insured assistance (NAP) program in order to qualify for the SURE program. Senate and House versions of the 2012 Farm Bill repeal direct payments, ACRE and SURE programs and introduce various shallow loss programs (some are free farm programs to be delivered through FSA, while others are similar to crop insurance programs and are to be delivered by AIPs), thus, farmer’s choices are anticipated to be become even more complex and difficult. Agents may be on the front-lines of the delivery of the 2012 Farm Bill’s supplementary revenue proposals and the study needs to consider the additional training

required, the time involved in working with farmers and the increased errors and omissions cost to agents.

As mentioned above, the agent's role in providing service to farmers will become increasingly critical. Agents mostly reside in rural areas and work closely with farmers in selecting appropriate crop insurance products and coverage that best serve farmers' needs and fit their risk profiles. Agents play the role of matchmaker between insurers, insurance products, and farmers and reduce the search costs. Agents have extensive educational requirements and develop additional expertise over time. The fact that many agents work for more than one company can benefit farmers as the agent will seek out the company that provides the best service and claims handling. Commissions provide a strong incentive to help to align the interests of agents with farmers by encouraging the agent to build a strong reputation and maintain a long-term relationship with the farmer, which is possible only if the agent provides good value to the farmer. According to the principal-agent theory in economics, a compensation scheme that does not align the agent's incentives with the agent's efforts can discourage a high level of effort (Cummins and Doherty, 2009).

The study should examine the impact of commodity prices on the cost of delivery of the program. While it is evident that commodity prices have a direct impact on the premiums collected, prices may also influence cost. This certainly is true at the AIP level since higher commodity prices result in higher liability exposure and, therefore, greater costs for meeting RMA's capital requirements. The study should examine whether higher commodity prices also affect agents' costs of doing business. Gross premiums are based on insured liability, and both have grown steadily over the life of the program. Increases in participation, higher coverage levels, new plans of insurance, and rising market prices have contributed to the increase in liability and gross premiums over time. Compensating agents primarily at a fixed percentage of premium (a long-standing tradition in insurance industry) would have materially contributed to increased agent compensations in dollar terms due to the high market prices during the past few years but the recently introduced A&O cap prevents that. Even though increased prices may not directly increase the per policy transaction cost, the value of the insured asset increases, which can increase agent workload by creating increased farmer interest in comparing the available risk management choices, which provides increased utility in terms of peace of mind and financial stability to the insured farmer. In other words, the additional agent compensation resulting from

high crop prices is consistent with the value-added (Cummins and Doherty, 2005). The study needs to consider whether the incentives provided ensure a highly effective sales and service process. Furthermore, the supply of crop insurance, as measured by market penetration, needs to be examined for various commodities and geographic areas to ensure that the program is meeting the needs of producers and providing high levels of protection. If crop insurance is to be an effective substitute for disaster assistance, incentives need to be structured in a way to ensure broad participation in the program.

The current SRA limits the amount of A&O payable to AIPs pursuant to section III(a)(2), and also limits the amount of compensation payable to agents in section III(a)(4). Subsequent to execution of the SRA, RMA decided that payments to agents for company required processing costs would be a permissible exception to the compensation limitations, and it deemed the maximum level of additional compensation to be equal to 5% of A&O. This is set forth in MGR-10-011.1. Since contractor will be expected to study costs of delivery, contractor should be expected also to determine more specifically whether 5% of A&O is an appropriate number for the exception made by RMA to the compensation limitations. Contractor should be expected to determine if RMA's definition of processing (§ 11(a) of MGR-10-011.1) is appropriate.

Costs associated with meeting regulatory requirements should be studied. Since such requirements change over time (witness changes envisioned in Appendix III through reinsurance year 2014), costs to AIPs and agents of meeting new requirements should be considered in this portion of the study. This includes such items as high dollar reviews, mandatory training activities, the expense of maintaining Information Technology systems in light of the ever-changing requirements of the program, and the cost of addressing news initiative being pursued by RMA. The contractor needs to have a clear understanding of the effort involved in administering a program coast to coast with over 100 different crops. Without a clear understanding of the cost drivers, the analysis may be constrained under an implicit assumption that the program is essentially static rather than a dynamic process requiring a continual investment of company funds and resources.

Contractor should provide reviews at regular intervals throughout the course of the study to report on project status and findings with industry representatives. Preliminary versions of reports prepared by contractor should be provided to industry for comments. The industry

representatives should be invited to attend any contractor presentations or discussions with RMA, USDA, Congress or Congressional staff members, or other groups. Contractor should hold a series of meetings with the entire industry to discuss the final results of the study. Finally, agency and industry representatives should have an opportunity to provide written responses as part of the final report.

An arbitrary timeline should not be established for completion of the study or for presentation of preliminary results. The study should be released only after it has been completed to the satisfaction of contractor, peer reviewers, industry stakeholders, and RMA.

NCIS and the industry again want to express their appreciation for the opportunity to provide constructive input for this important study. We, along with RMA, hope the study will provide accurate and insightful information regarding our industry. We share with RMA the interest in providing a stable and effective program that protects American agriculture in a manner that is responsible to taxpayers and the American public.

References:

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Federal Crop Insurance Program Delivery Cost Study

First Industry Presentation
Cost of Delivery Estimation Methodology
July 10, 2012





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Project Team

Project Team

KPMG LLP (“KPMG”) engagement team is made up of economists, actuaries, sampling specialists, survey specialists, and insurance industry specialists

- Jon Silverman, Ph.D. – Project Lead*
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- Vera Holovchenko, Ph.D. – Econometrician*
- Kayla Lamar – Analyst*
- Paul Li, Ph.D. – Lead Statistician
- Barb Theobald – Campos Market Research, Lead Survey Specialist
- Jerome Albright – Industry specialist
- Sharon Carroll – Actuary

*** Present today**



Introduction

Introduction

- In March 2012, Risk Management Agency (“RMA”) engaged KPMG to prepare a study of the economic costs of delivery for the Federal Crop Insurance Program (“FCIP”).
- Purpose of the Study
 - Identify and measure on a regional and national basis the current reasonable and necessary economic costs required for delivery of the FCIP.
- Motivation for the Study
 - The Government Accountability Office (“GAO”) April 2009 findings suggest that Administrative and Operating (“A&O”) payments have tripled between 2000 and 2009 due to the calculation method that takes into account the value of crop rather than actual cost of selling and servicing policies.
- Purpose of this Presentation
 - Discuss study objectives, proposed methodology, and receive industry feedback.
- Note: Data presented in this presentation are preliminary and should not be considered final.



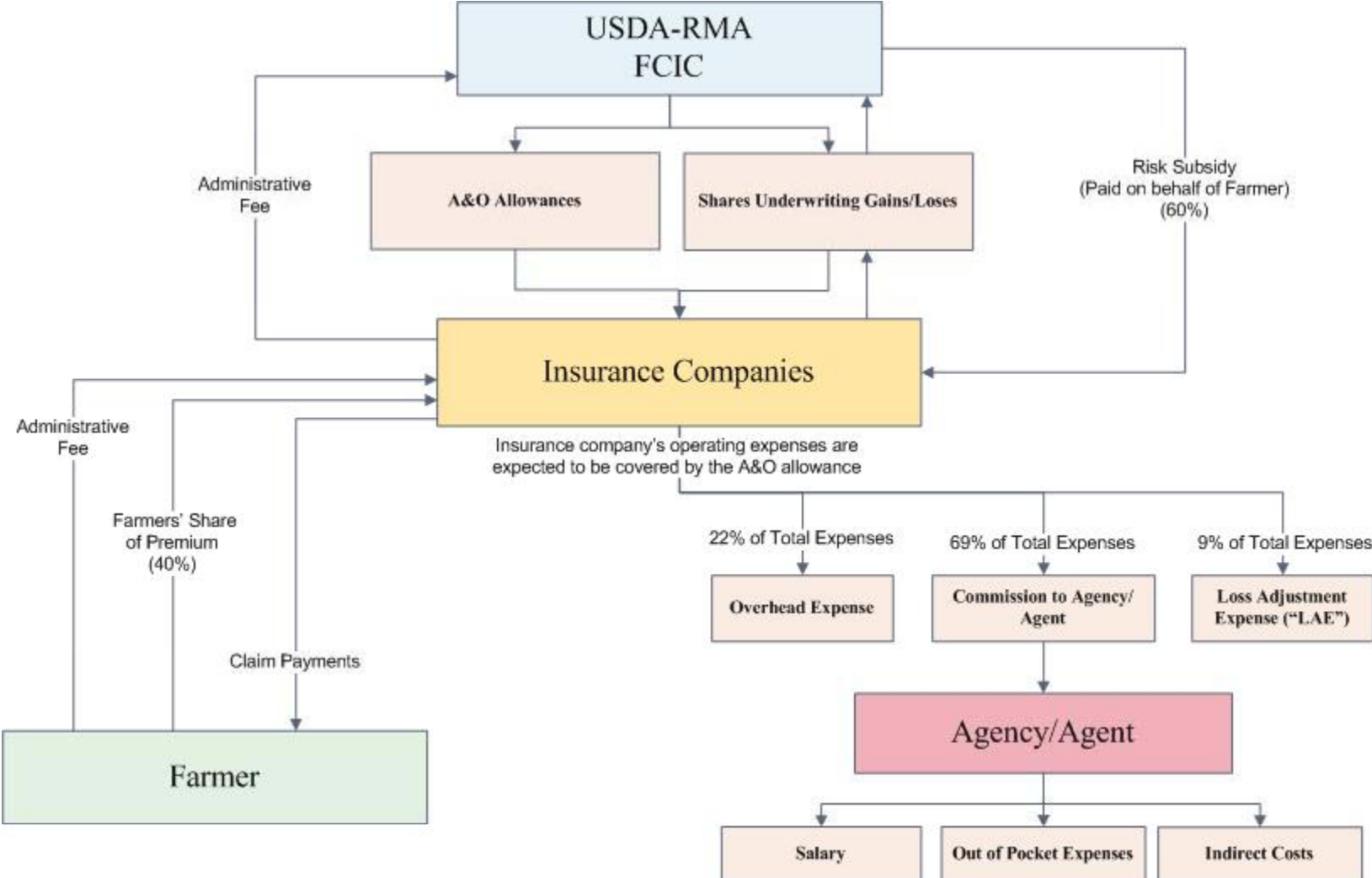
Background

Overview of the Federal Crop Insurance Program

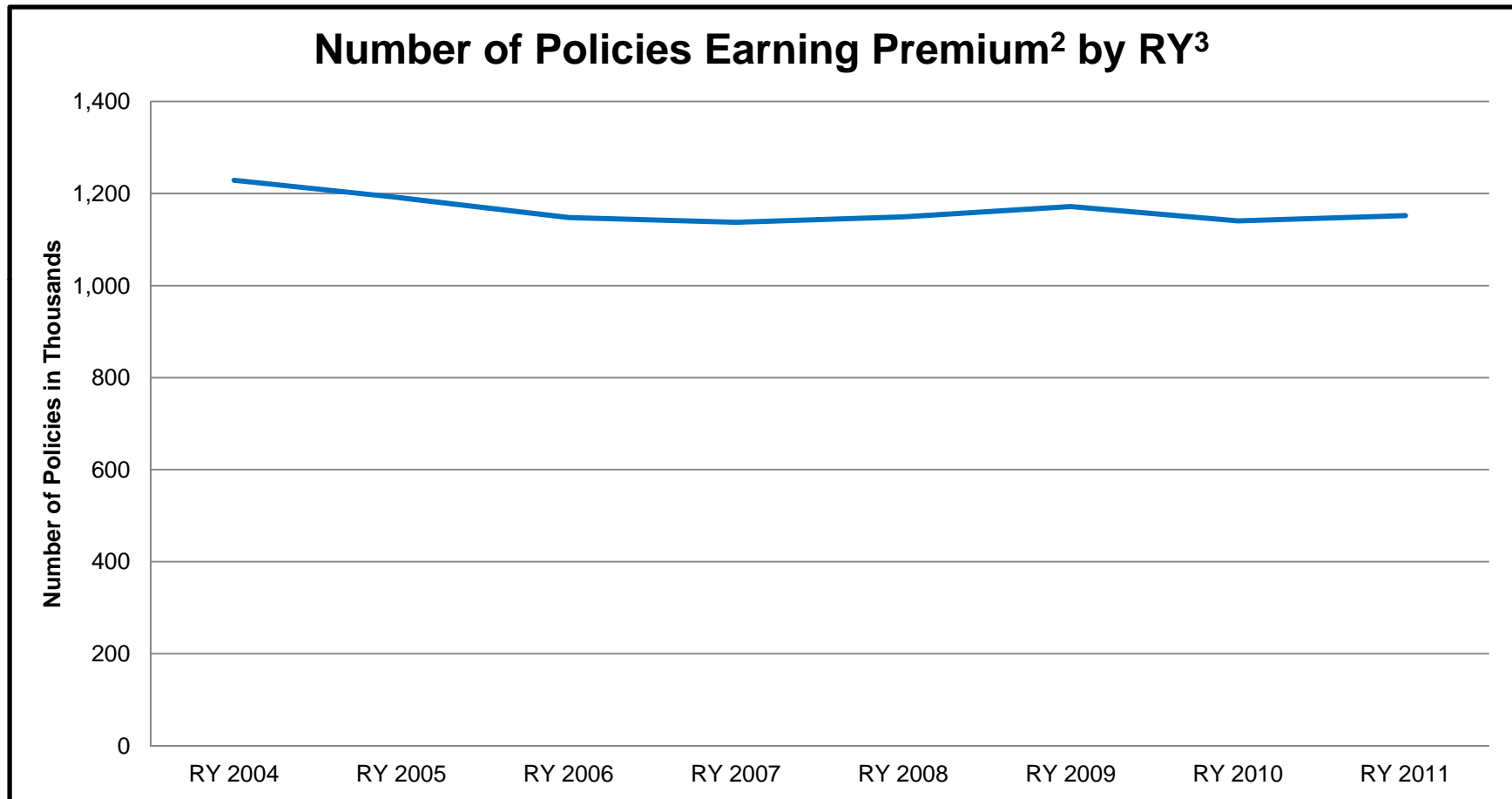
- In 2011, the Federal crop insurance program provided¹
 - coverage for 265.7 million acres
 - insured liability of \$114.2 billion
 - generated total premiums of \$12 billion of which \$7.5 billion were premium subsidies
 - \$10.8 billion in indemnity payments
- Insurance Agents in FCIP
 - About 12,400 agents sold federal crop insurance in Reinsurance Year (“RY”) 2011
 - 1.2 million policies earning premium were written in RY 2011
 - Average premium for policies earning premium was \$10,387 in RY 2011

¹ Source: http://www3.rma.usda.gov/apps/sob/current_week/sobrpt2009-2012.pdf as of 06-26-2012.

How Money Flows Through the Federal Crop Insurance Program



Number of Policies Earning Premium By RY



² Number of Policies data taken from the 2004 – 2011 Summary of Business ("SOB") information on the RMA website.

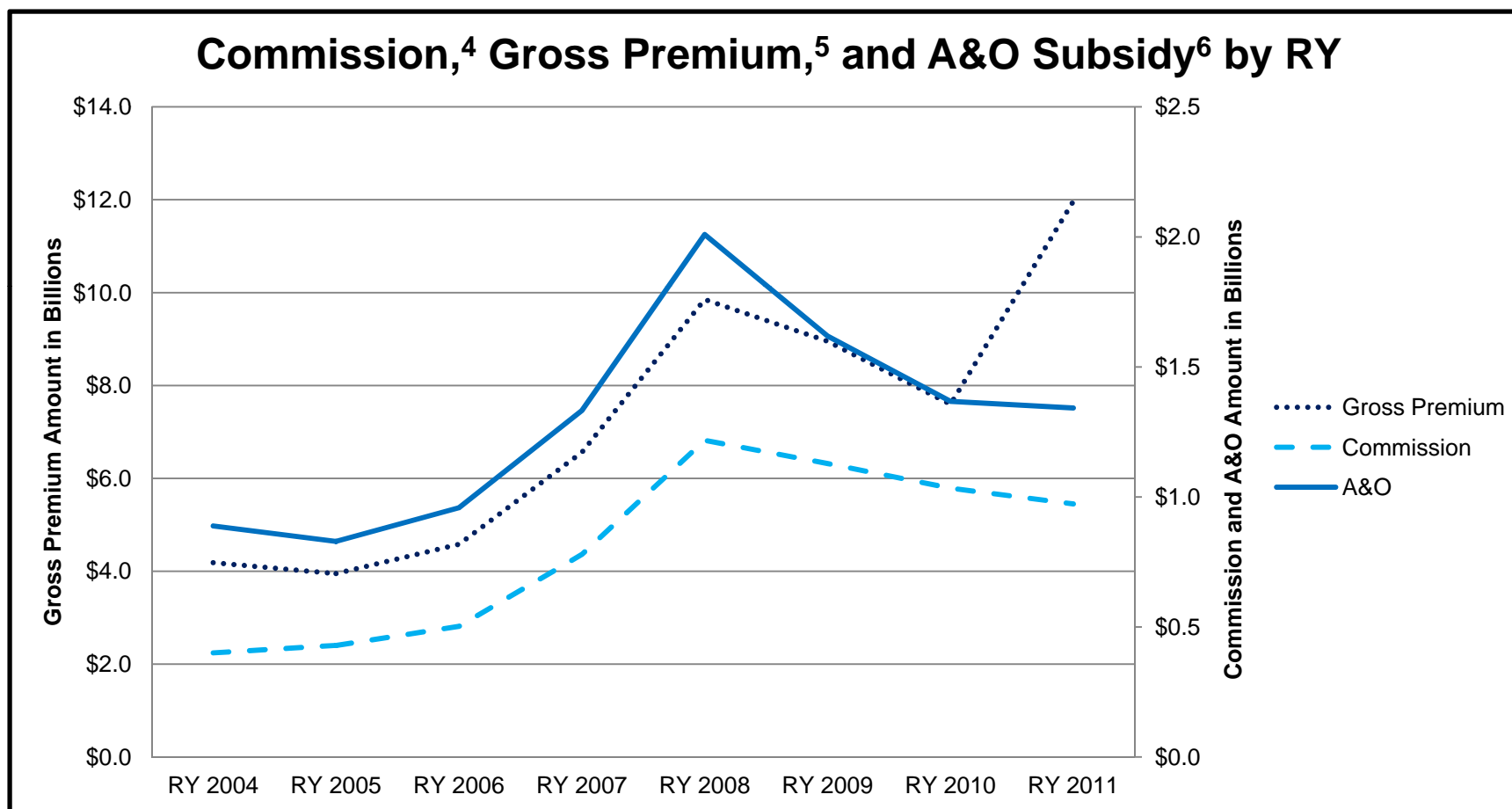
³ RY begins on July 1st and ends on June 30th of the following calendar year.

Special Features of the Federal Crop Insurance Program

FCIP has some unique features:

- Product homogeneity
 - RMA sets premium rates for all Federal crop insurance policies;
 - RMA establishes underwriting standards, policy terms and conditions, etc. for all Federal crop insurance policies; and
 - Companies compete for market share on factors other than price.
- FCIP premiums are not loaded for expenses. Instead, RMA pays AIPs the A&O subsidy to cover their operating expenses.
- Agencies/agents operate independently of the AIPs and can change company affiliations.
- AIPs must accept all eligible farmers in a state in which they operate.
- Extensive quality control reviews are required for the delivery of a government program.
- Selling and servicing the Federal crop insurance policies requires greater frequency of contacts between an insurance agent and the insured farmer relative to Property and Casualty (“P&C”).

Commission, Gross Premium, and A&O Subsidy by RY

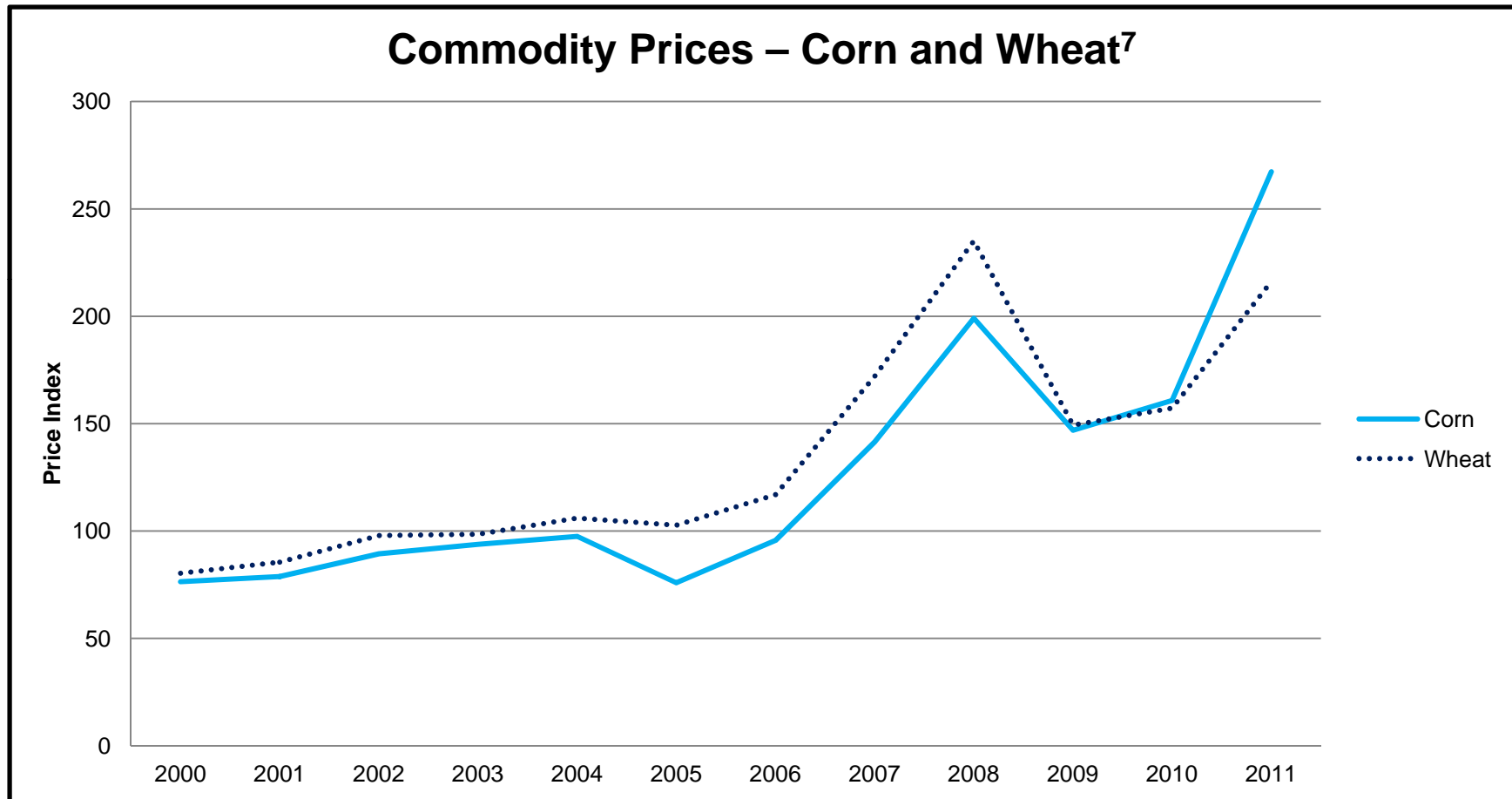


⁴ RMA provided total expense templates containing Commission data.

⁵ The RMA website provided the SOB containing the Gross Premium data.

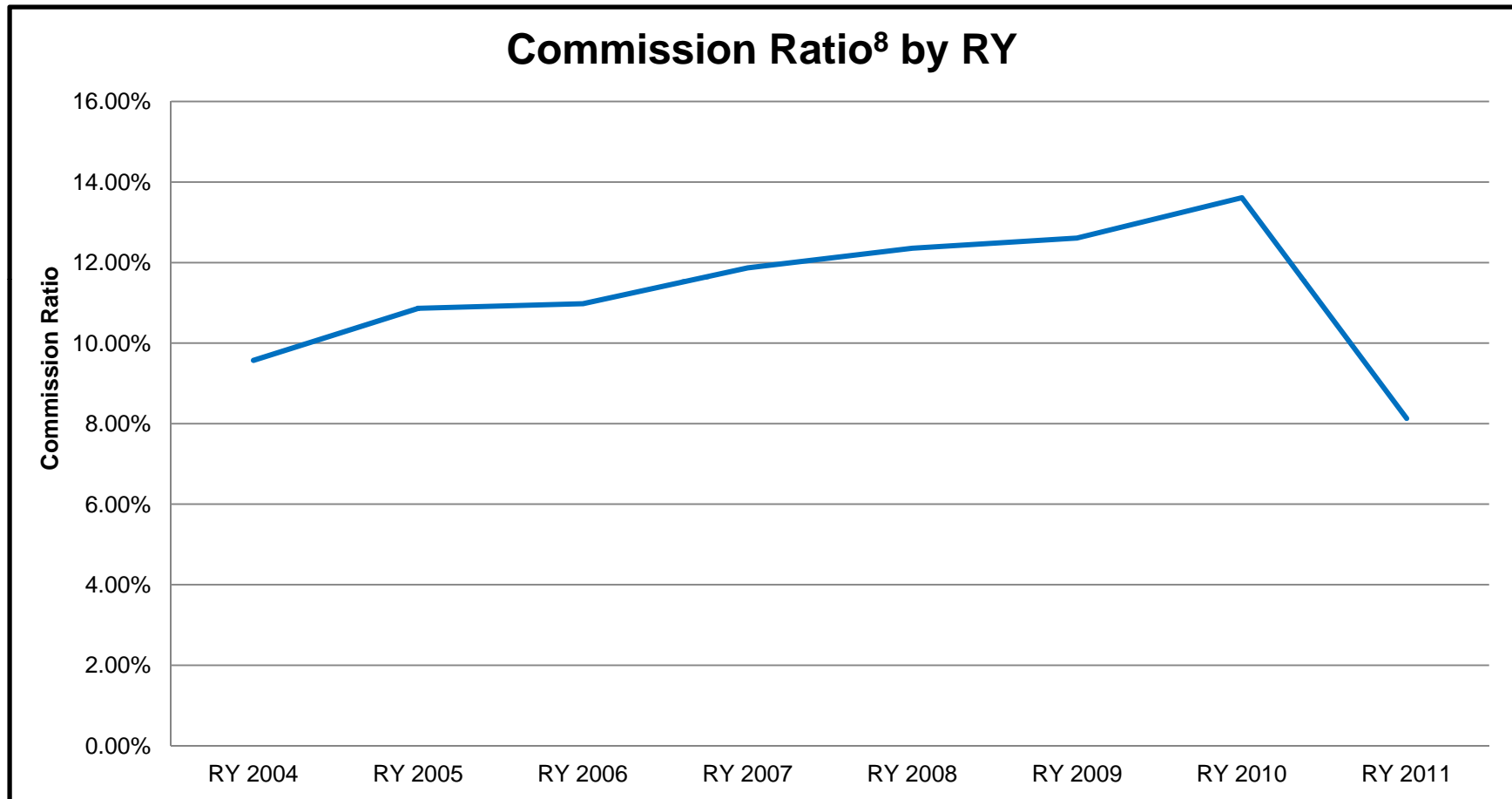
⁶ RMA provided internal accounting reports containing A&O data.

Commodity Prices for Corn and Wheat



⁷ <ftp://ftp.bls.gov/pub/time.series/wp/> as of 07-02-2012.

Commission Ratio by RY



⁸ Commission Ratio is equal to Commission amount divided by Gross Premium value. Commission data was taken from the total expense templates provided by RMA. Gross Premium Data was taken from the SOB on the RMA website.

Previous Studies on A&O Payment and AIP Profitability

■ 2009 GAO Report⁹

- A&O payments nearly tripled between 2000 and 2009 because the method used for calculating A&O payments considers the value of the crop rather than the actual costs for selling and servicing the Federal crop insurance.

■ 2010 Grant Thornton Report Commissioned by NCIS¹⁰

- All studies conducted by Grant Thornton consistently show that the MPCl program is *less profitable* than the P&C industry as a whole in the area of profitability and *more efficient* than the P&C industry in the area of expense management.

■ 2009 Milliman Report Commissioned by RMA¹¹

- From 1989 -2008, the estimated earned rate of return on equity for MPCl insurers was approximately 17.1 percent as compared with an average reasonable rate of return of 12.8 percent over the same period.

⁹ "Crop Insurance: Opportunities Exist to Reduce the Cost of Administering the Program." GAO-09-445, U.S. Government Accountability Office, April 2009.

¹⁰ "Federal Crop Insurance Program: Profitability and Effectiveness Analysis 2010 Update" Grant Thornton, LLP. Prepared on behalf of National Crop Insurance Services, Inc., January 13, 2011.

¹¹ "Historical Rate of Return Analysis." Milliman, Inc. Prepared for the Risk Management Agency , August 18, 2009.

RMA Requests an Independent Study to Determine the Economic Cost of Delivery

- A number of previous studies have typically approached the issue of cost of the crop insurance program from an accounting perspective, with the assumption that the accounting costs reported by AIPs by themselves represent the economic cost of delivery of the FCIP:
 - Although the sales expenses reported by AIPs are likely to be highly correlated with the level of efforts required for the agents to sell and service the crop insurance policies, they may not be an accurate reflection of the true program delivery cost incurred by the insurance agents;
 - For LAE and overhead expenses, significant disparities are not presumed to exist between accounting costs (AIP reported expenditures) and economic costs, and these categories are comparatively small relative to sales expenses.
- No study has been conducted to appropriately measure the economic cost of delivery for the FCIP, especially the economic cost of delivery incurred by insurance agencies/agents in selling and servicing Federal crop insurance.

Difference between Accounting and Economic Costs

■ Accounting Costs

- Accounting costs are reported by AIPs to RMA and State insurance departments.

■ Economic Costs

- Economic costs are more difficult to identify and analyze.
- Economic costs can exceed accounting costs because there is no recognition on the books and records of the opportunity costs of an activity, e.g., the opportunity cost of use of an owned building for one activity is the rent forgone if the building is rented out.
- Accounting costs could also exceed economic costs if the underlying cost of resources could be acquired at a lower price, e.g., at their opportunity cost or value in next best use.
- RMA is concerned that accounting costs of the delivery could be greater than economic costs if the method used to compensate agents is driven by premium linked to commodity prices rather than say by level of effort required or wage in an alternative use.



Study Objectives

Determine the Economic Cost of Crop Insurance Delivery

Determine Costs Incurred by Insurance Agencies/Agents

■ Sales Expenses

- ❑ Costs incurred by insurance agencies and their agents who sell crop insurance to farmers.
- ❑ Costs of actual provision of services, including salaries, out of pocket expenses (e.g. transportation), and other overhead expenses (e.g. office expenses).
- ❑ The sales expenses incurred by the AIPs represent the revenue of the insurance agency/agent rather than their cost.

Determine Costs Incurred by AIPs

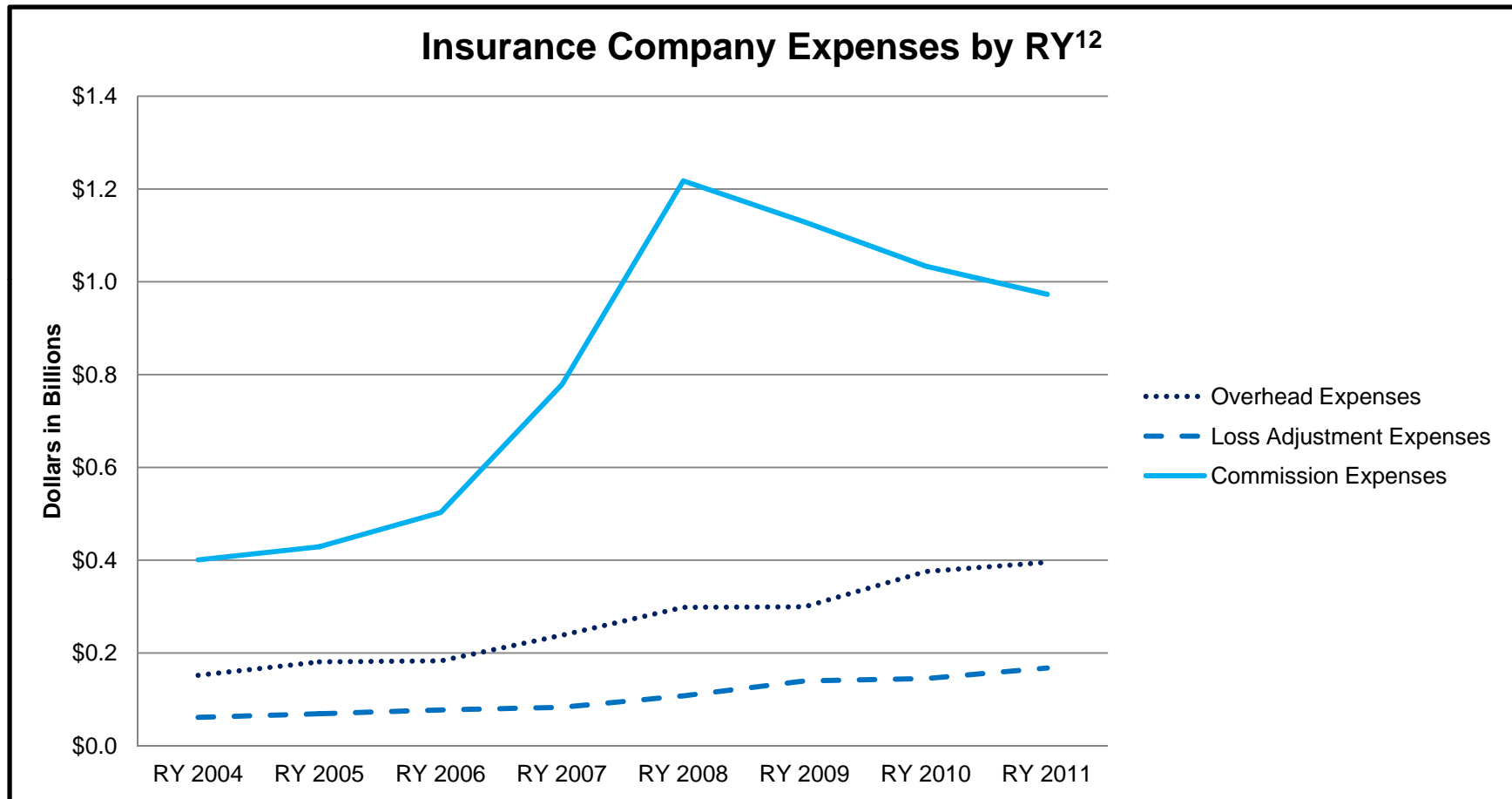
■ Loss Adjustment Expenses

- ❑ Fees paid to insurance adjusters to verify claims.

■ Overhead Expenses

- ❑ Company overhead, such as employee salaries and labor burden, information technology, general and administrative expenses, underwriting expenses, agent and adjuster training costs, quality control, and maintaining capital levels required by Federal regulations.

Insurance Company Expenses by RY



¹² RMA provided total expense templates containing the expense data.

Consider Factors Potentially Affecting the Program Delivery Cost

- Factors that might potentially affect the LAE and Overhead Expenses incurred by AIPs:
 - Geographical Regions: by state or by other geographical segmentation (e.g. Corn Belt), and
 - Size of the Company: measured primarily by premiums written each year.
- Factors that might potentially affect the cost of delivery incurred by insurance agencies/agents:
 - Geographical Regions: by state or by other geographical segmentation (e.g. Corn Belt),
 - Agent Type: captive vs. independent Agents,
 - Policy Characteristics: new policies vs. renewal policies,
 - Crop Coverage: regular crops (e.g. corn, wheat, soybean) vs. specialty crops, and
 - Type of Insurance: Catastrophic Loss Coverage (CAT), Area, Yield and Actual Production History (APH)/Revenue.



Technical Approach

Understand Operations of the Federal Crop Insurance Program

- To better understand the operations of the FCIP, we conduct interviews with:
 - AIPs
 - Crop Insurance Agents
 - Insured Farmers
- Information obtained from the interviews will assist us in designing survey instruments and determining the type of data we need to collect from insurance agents and insured farmers.

Analyze LAE and Overhead Expenses Incurred by AIPs

- Use RMA data to analyze LAE and Overhead Expenses
 - Use RMA data reported by AIPs to analyze costs AIPs incurred in selling and servicing Federal crop insurance.
- Perform benchmarking analysis to compare operational costs of MPCl insurers with those of insurers in other P&C lines of business.
 - Financials reported by AIPs to RMA and financials for insurers in P&C lines of business from SNL will be used for this analysis.
 - Compare expense ratios for the MPCl insurers with expense ratios observed in other P&C lines of business.

Analyze LAE and Overhead Expenses Incurred by AIPs

- The benchmarking analysis includes a comparison of the following key ratios across industries:
 - ❑ Commission Ratio: measures expenditure insurers pay to its sales force
 - ❑ Taxes, Licenses, and Fees Ratio
 - ❑ Overhead Expense Ratio
 - ❑ Total Expense Ratio: defined as sum of all three ratios above, measures overall operational efficiency
 - ❑ LAE Ratio: measures expenditure insurers pay to the adjusters
 - ❑ Loss Ratio: measures overall effectiveness in risk control and management
 - ❑ Combined Ratio: measures overall profitability
 - ❑ Delivery Expense Ratio: defined as Total Expense ratio plus LAE ratio, measures the delivery expense incurred by insurance company in selling and servicing the respective insurance policies

Develop Cost of Delivery Estimate for Insurance Companies and Agents

- AIP costs directly from benchmark insurance industry data.
- Estimate insurance agency/agent costs by building up costs using:
 - Statistics of Income (“SOI”) Bulletin for Sole Proprietorship Returns
 - The income statement for insurance agencies and brokerages reported by SOI division at the Internal Revenue Service, and
 - Industry-level income and itemized expenses such as commissions, salaries and wages, utilities, and office expenses are reported.
 - Bureau of Labor Statistics
 - Wage data for insurance sales agents by state.
 - Insurance Agents Data by State and Agent Commission/Compensation Data by State (RMA)
 - Survey of the Insurance Agents
- Develop a range of AIP costs using distribution of expenses and by considering possible variations in assumptions.

Develop Cost of Delivery Estimate for Insurance Agents

- The percentage of itemized expenses over income from SOI serves as our baseline percentage estimate of expenses incurred by Federal crop insurance agents.
- The baseline percentages need to be properly adjusted to account for the difference between selling and servicing Federal crop insurance and other lines of insurance.
- Appropriate adjustments will be made to the baseline estimates based on the survey data:
 - Sampled insurance agents will be asked to quantify the variations in the percentage of expense over income for each category of expenses incurred relative to the baseline percentages.
 - Reported variations (either downward or upward adjustments) in percentages will then be used to calculate the appropriate expense percentages applicable for selling and servicing Federal crop insurance.
 - Together with the average commission/compensation calculated using the RMA data (Agent Commission/Compensation and Insurance Agent data), develop a delivery cost estimate for each sampled insurance agent.

Conduct Surveys of Crop Insurance Agents and Insured Farmers

- The purpose of the surveys of the insurance agents is to collect relevant cost data incurred by the insurance agents in selling and servicing Federal crop insurance policies. Information to be gathered from the survey includes:
 - ❑ Time insurance agents spend tasks required for selling and servicing the Federal crop insurance;
 - ❑ Out of pocket expenses incurred by insurance agencies/agents for support staff and travel;
 - ❑ Variation in percentages of expense over the income relative to the SOI baseline estimates; and
 - ❑ Other general background information, e.g., geographical region, types of crop insurance sold, agent type, crop coverage, and number of crop insurance policies sold.
- A parallel survey of the insured farmers to whom the sampled insurance agents sell crop insurance will be conducted to determine the level of services (e.g., number of insurance agent visits, educational services, and other services) necessary for farmers to make an informed decision.
 - ❑ Data gathered from survey of insured farmers serves as a consistency check and are not to be directly used to estimate the cost of delivery incurred by insurance agent.

Determine Sample Sizes and Select Representative Samples

Insurance Agents

- Approximately 12,400 insurance agents sold crop insurance in RY 2011.
- Of these agents approximately 20 percent will be sampled.
- The sample is selected to ensure insurance agents in all of the following regions are represented:
 - ☐ Midwest
 - ☐ Plains
 - ☐ South
 - ☐ West
 - ☐ Mountain
 - ☐ Northeast

Determine Sample Sizes and Select Representative Samples

Insured Farmers

- A sample of farmers insured with the sampled agents will be selected.
- Of the farmers, 20 percent of those associated with sampled agents will be sampled.
- The sample is selected to ensure insured farmers in all of the following regions are represented:
 - ☐ Midwest
 - ☐ Plains
 - ☐ South
 - ☐ West
 - ☐ Mountain
 - ☐ Northeast

Data Analyses: Other Statistical Analyses

- **Baseline Trend Analysis**

- Compare the trends in insurance agent wage to the trends in actual agent commissions paid by AIPs.

- **Statistical Analysis on Agent Compensation**

- Using RMA data on agent compensation and macroeconomic variables in public domain to investigate the influence of various factors on agent compensation.

- **Statistical Analysis on LAE and Overhead Expenses**

- Using RMA data on LAE and Overhead expenses and macroeconomic variables in public domain to investigate the influence of various factors on LAE and Overhead Expenses.

- **Statistical Analysis on Cost of Delivery by Insurance Agent**

- Using costs of delivery estimated through the survey and other macroeconomic variables to investigate the influence of various factors on the cost of delivery incurred by insurance agent.

Challenges

■ Increase the Response Rates for Agents and Farmers

- The expected response rates for agents and farmers are likely to be low

- Ways for us to increase the response rates of the agents

 - ❖ Survey Format (internet, phone, mail)

 - ❖ Survey Time

 - ❖ Survey Duration

- Suggestions /Potential Assistance from AIPs

 - ❖ Awareness Campaign

 - ❖ Advance Notification Email

 - ❖ Reminder Email

- In estimating the cost of delivery by insurance agents, consider the myriad of differences in levels of selling efforts across geographies, types of crops, insurance plans, coverage levels, and sizes of acreage.



Questions and Comments



cutting through complexity

Thank you

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