UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

July 26, 1985

B-209866

The Honorable Ed Jones
Chairman, Subcommittee on Conservation,
Credit, and Rural Development
Committee on Agriculture
House of Representatives

Dear Mr. Chairman:

Subject: Information on the Federal Crop Insurance Corporation's 1986 Standard Reinsurance Agreement (GAO/RCED-85-155)

On May 13, 1985, you requested that we review the 1986 reinsurance agreement between the Federal Crop Insurance Corporation (FCIC) and insurance organizations, which are called reinsured companies. FCIC is a government-owned corporation whose purpose is to promote the national welfare by improving the economic stability of agriculture through a program of crop insurance. Currently, it is providing $6.6 billion worth of insurance protection to farmers in 49 states and in over 3,000 counties.

In response to your request and a subsequent meeting with your office, this letter provides information on

--how the 1986 reinsurance agreement will work;

--how the agreement compares to prior years' agreements; and

--how reinsured companies could fare financially under the 1986 agreement, as well as the previous years' agreements, including information on the gain and loss distribution between FCIC and the reinsured companies.

In addition, we agreed to provide a brief overview of FCIC's overall financial condition as it relates to the Corporation's ability to meet its financial obligations over the next several months.

A brief summary of the information we obtained in response to each of these points follows. Our detailed responses are included in appendixes I and II which deal with FCIC's reinsurance program and its financial condition, respectively.

Under the authority of the Federal Crop Insurance Act of 1980 (Public Law 96-365), the FCIC established the reinsurance program in 1981. Under the reinsurance program FCIC has entered into agreements with private insurance companies to sell, service, and adjust insured losses on the crop insurance policies the companies sell to producers of agricultural commodities. The companies write insurance policies in their names and obtain protection from FCIC against most of their insured losses. This protection from FCIC is called reinsurance. As the reinsurer, FCIC is liable for the major share of any underwriting[1] losses but also receives the major share of any underwriting gains. The 1986 reinsurance agreement and prior agreements all work on these basic concepts.

However, despite the basic conceptual similarities among all the agreements since 1981, there are significant differences between the agreement for 1986 and the prior years' agreements. According to FCIC officials these changes were necessary to increase participation and improve crop insurance coverage to farmers. The differences in the 1986 agreement include:

1. A new requirement that companies must insure any eligible farmer's crop, provided the company insures the same crop elsewhere in the state in which the farmer is located. This provision is intended to assure that all eligible farmers can obtain crop insurance from reinsured companies. Companies were permitted to selectively insure against losses under prior agreements.

2. A number of provisions that allow a company to relinquish portions of its business to the FCIC. These provisions go beyond the reinsurance agreements of prior years in that they permit reinsured companies to transfer business to FCIC for which they do not wish to retain the liability for losses. For example, under the 1986 agreement a company can relinquish 95 percent of all insurance liabilities and premiums on high risk policies to FCIC provided it does not exceed 10 percent of a company's total business. According to FCIC officials, the overall purpose for including these provisions in the new agreement is to permit the reinsurance companies to better manage insurance risks.

[1]Underwriting losses occur when claims paid exceed premium income. Correspondingly, underwriting gains occur when premium income exceeds claims paid.

3. A new provision allowing reinsured companies operating in a limited geographic area (e.g., one or two states) to exchange some of their local insurance business with FCIC for an equivalent amount of insurance business in other areas of the country. Such an exchange allows a company with localized business to spread some of its risk to a broader geographic area, thereby reducing the risk exposure associated with any specific geographic area.

4. Provisions that increase the maximum share of underwriting gains and losses companies can realize from 11.33 percent to 15.375 percent of premiums. The purpose of this change is to provide increased incentives for companies to participate in the reinsurance program.

5. A change in the way FCIC reimburses companies for expenses incurred in the sale of crop insurance. Under the 1986 agreement and prior years' agreements, FCIC compensates companies for administrative expenses incurred in selling insurance that is reinsured by the FCIC. The 1986 agreement changes the reimbursement rates for these expenses.

FCIC's financial situation has deteriorated since 1980. This situation exists essentially because premiums charged have been too low and a series of disastrous weather has plagued certain crops covered by the FCIC's insurance program. Consequently, the FCIC has expended all of the cash available from its insurance program fund to pay claims on insured losses. On July 17, 1985, the Secretary of Agriculture announced that the FCIC was suspending payments on insured losses. On March 26, 1985, in anticipation of needed additional funds to pay insurance claims, FCIC transferred $50 million from its administrative fund (used for payroll and other operating expenses) to its program fund. Consequently, FCIC is now anticipating a shortage in its administrative fund this fiscal year. In fact, on July 22, 1985, the Manager of the FCIC announced that unless a supplemental appropriation was passed, the administrative fund would be depleted on or about August 25, 1985. In order to meet its obligations for fiscal year 1985, FCIC officials estimate FCIC will need to replace the $50 million from its administrative fund and will need $113 million to meet insurance claims through the end of this fiscal year.

Our review was done at FCIC's offices in Kansas City, Missouri, and Washington, D.C., between June 1 and June 21, 1985. At your request we did not obtain official agency comments on this report. We did, however, discuss the report's contents with the Manager of the FCIC. His comments have been incorporated into the report as appropriate. The data in this report were taken from records and documents provided by the FCIC; we did not attempt to independently verify the accuracy of the data provided. Our calculations and comparisons are all based on these data. We did not attempt to determine if the 1986 agreement is in the goverment's interest, or the extent to which it would help solve the FCIC's financial crisis.

We plan no further distribution of this report for 30 days, or until you release it publicly. At that time we will send copies to the Director, Office of Management and Budget; the Secretary of Agriculture; and other interested parties.

Sincerely,

J. Dexter Peach
Director

Contents

ILLUSTRATIONS

ABBREVIATIONS

FCIC	Federal Crop Insurance Corporation
GAO	General Accounting Office
USDA	U.S. Department of Agriculture

INFORMATION ON FCIC's 1986

STANDARD REINSURANCE AGREEMENT

INTRODUCTION

The Federal Crop Insurance Corporation (FCIC), a wholly government-owned corporation, was created in 1938 as an agency of the U.S. Department of Agriculture (USDA). Its purpose is to promote the national welfare by improving the economic stability of agriculture through a sound program of crop insurance.

Before 1980, the crop insurance program operated on a limited basis, covering only certain agricultural commodities in selected counties. It was characterized by some as experimental. The Federal Crop Insurance Act of 1980 (Public Law 96-365) changed this by authorizing a nationwide crop insurance program to protect agricultural producers' production investment against essentially all unavoidable risks. These include losses due to many kinds of perils, including flood, drought, hail, and insect infestation. Today, FCIC provides crop insurance protection worth about $6.6 billion to 49 states and over 3,000 counties.

The 1980 act also authorized and directed FCIC to provide reinsurance, to the maximum extent practicable, to insurers that protect producers of any agricultural commodity. The reinsurance is to be based on terms and conditions determined by FCIC's Board of Directors and on sound reinsurance principles. The legislation also allows that insurers can include, among others, private insurance companies or pools of such companies, or state and local governmental entities.

FCIC initiated the reinsurance program for crop year[1] 1981. Under this program, FCIC enters into an agreement with insurers, which are called reinsured companies. Reinsured companies sell crop insurance to producers, service the policies, collect premiums, and adjust any losses on the policies. FCIC determines the extent of insurance coverage and premium rates to be offered by the reinsured companies. The reinsured companies write insurance policies in their names and obtain protection from FCIC against most of the risks that could result in underwriting losses (amounts by which insured losses exceed premiums) incurred in selling insurance. This protection from FCIC is called reinsurance. As the reinsurer, FCIC is liable for the major share of any underwriting losses and shares in any underwriting gains (amount by which premiums exceed insured losses). The terms and conditions under which reinsured companies operate are set out in the Standard Reinsurance Agreements. FCIC has finalized a new agreement for crop year 1986.

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[1]A crop year is the calendar year in which a crop is harvested.

OBJECTIVES, SCOPE, AND METHODOLOGY

As agreed with the Chairman's office, our objectives were to provide the Chairman with information on the following points, each of which is discussed in this appendix:

--How the 1986 reinsurance agreement will work.

--How the agreement compares to prior years' agreements.

--How reinsured companies could fare financially under the various years' agreements, including information on the gain and loss distribution between FCIC and the reinsured companies.

In addition, we agreed to provide a brief overview of FCIC's financial position as it relates to the Corporation's ability to meet its financial obligations over the next several months. This information is contained in appendix II.

Our review was conducted at FCIC's offices in Kansas City, Missouri, and at its headquarters in Washington, D.C., from June 1 through June 21, 1985. At these locations we interviewed officials responsible for administering the reinsurance program, and reviewed applicable legislation, regulations, publications, and pertinent program procedures as they related to the reinsurance agreements formerly and currently being used and developed. We also coordinated our work with USDA's Office of Inspector General and reviewed its applicable audit reports. While we did not obtain official agency comments, we did discuss the contents of the report with the Manager of the FCIC, and his comments have been incorporated into the report where appropriate.

The data in this report were taken from records and documents provided by the FCIC; we did not attempt to independently verify the accuracy of the data provided. In order to answer the first two questions we studied the documents, records, and publications of the FCIC and interviewed knowledgeable agency officials. In order to respond to the third question, we computed the gain and loss ratios for FCIC's and the reinsured companies' for each year's agreement for a range of loss ratios. Finally, we collected financial data, background documents, and interviewed knowledgeable agency officials to provide an overview of the FCIC's financial condition. We traced the FCIC's historical experience in terms of premium income and loss claims paid, described its present situation and explained its current cash needs, according to agency officials, to meet its obligations over the next several months. We did not attempt to determine if the 1986 agreement is in the government's interest, or the extent to which it would help solve the FCIC's financial crisis.

Before providing our responses to each of the concerns raised by the Chairman, it is necessary to first provide an understanding of how the prior reinsurance agreements worked. Accordingly, the following section of the report discusses how the reinsurance agreements worked for crop years 1981 through 1985.

HOW PRIOR REINSURANCE AGREEMENTS WORKED

Separate Standard Reinsurance Agreements were in effect for crop years 1981, 1982, and 1983. The agreement for 1983 was used with minor revisions in crop years 1984 and 1985. The features of these agreements were the subject of two earlier GAO reports[2] and are highlighted below. The major features of these prior agreements involve the limits placed on reinsured companies' risks, the share of gains and losses that can be experienced by the reinsured companies, and the expense allowances provided by FCIC to the reinsured companies.

Limits on reinsured companies' risks

The Standard Reinsurance Agreements, up to and including the 1985 agreement, did not require the reinsured companies to write insurance for any eligible producer; a particular crop; or a particular area, county, or state. The companies decided these matters for themselves. Accordingly, the reinsured companies were able to limit the risk they were willing to assume.

In addition, the reinsured companies could further limit their amount of risk in a state and/or a county. Each company established a dollar limit by county and/or state in which it shared in the total gain or loss; insurance above the limit was transferred to FCIC.

Reinsured companies' share of gains and losses

A reinsured company's share in underwriting gains and losses generally increased with each new agreement. For crop year 1981, the maximum amounts of a company's gain and loss were set at 5 percent and 8.5 percent, respectively, of premiums. For crop year 1982, these percentages were each set at 8 percent for both gains and losses. For crop years 1983, 1984, and 1985, both the gain and loss percentages were set at a maximum of 11.33 percent of premiums.

In 1981 and 1982, a reinsured company experienced no gain or loss when the loss ratio[3] was 100. However, in 1983, 1984, and

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[2]More Attention Needed in Key Areas of the Expanded Crop Insurance Program (GAO/RCED-84-65, Mar. 14, 1984); Information on the Federal Crop Insurance Corporation's 1983 Standard Reinsurance Agreement (GAO/RCED-83-114, Mar. 9, 1983).

[3]A loss ratio is determined using the formula: insured losses ÷ total premiums x 100. For example, a loss ratio of 100 means that premiums received equal loss claims paid.

1985 companies did not share in underwriting losses until the loss ratio exceeded 128.33. In other words the FCIC was responsible for losses from 100 percent up to 128.33 percent of premiums.

Expense allowance provided to reinsured companies

Independently of any underwriting gains or losses on crop insurance sold, the FCIC reimbursed reinsured companies for administrative expenses. Under the agreements applicable for crop years 1981 through 1984, FCIC provided the reinsured companies an administrative and operating expense allowance of 27 percent of the company's book premium (farmer-paid premium plus federal subsidy[4]) for new business and 22 percent of the book premium for any carryover business. In addition, for their work in determining and assessing losses--normally called claim adjustment work--FCIC paid the companies 4 percent of book premiums and 3 percent of any losses paid out under the companies' policies.

For crop year 1985, FCIC established a single rate of 28 percent of book premiums for a company's administrative and operating expense allowance for all business (new or carryover). This rate included the payment of 4 percent of book premium for indirect claim adjustment expenses. Further, in contrast to the earlier agreements, the additional 3 percent of losses FCIC formerly paid on a company's policies for direct claim adjustment expenses was changed, as shown below, to a sliding scale depending on the company's loss ratio for the crop year.

Loss ratio range	FCIC payment rate
Zero to 100.00	3.0 percent of insured losses in this range
100.01 to 200.00	2.5 percent of insured losses in this range
200.01 to 300.00	2.0 percent of insured losses in this range
300.01 to 400.00	1.5 percent of insured losses in this range
Above 400.01	Zero percent of insured losses in this range

These 1985 revised payment rates were optional in that the companies could accept these rates or continue operations under the rates set out in the earlier Standard Reinsurance Agreements. Of the 48 companies under agreement for crop year 1985, 38 elected to accept the revised rates while 10 continued under the prior rates.

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[4]FCIC provides premium subsidies in order to lower the premium expense of farmers obtaining FCIC crop insurance.

HOW THE 1986 STANDARD REINSURANCE AGREEMENT WORKS AND HOW IT COMPARES WITH PRIOR AGREEMENTS

FCIC recently finalized a new Standard Reinsurance Agreement for crop year 1986. While the basic concept of FCIC providing reinsurance to commercial companies has not changed, there are significant differences between the prior agreements and the 1986 Standard Reinsurance Agreement. The major differences include

--a new requirement for reinsurance companies to offer crop insurance coverage to any qualified producer in a state where the reinsured company offers insurance for the producer's crop;

--a provision which allows a reinsured company to "cede"[5] 95 percent of the liability and premium on individual policies to FCIC, provided the value of the policies included does not exceed 10 percent of the company's crop insurance business;

--a requirement for reinsured companies to relinquish or cede at least 5 percent of their business to FCIC;

--a provision that limits the total amount of business a reinsured company can cede to FCIC to 57 percent of the company's business;

--a feature called a Portfolio Exchange provision, which allows any company with insurance sales concentrated in three or fewer states to spread its risks on a national scale by essentially exchanging business with FCIC;

--a new gain and loss formula which increases the maximum gain or loss for a company from 11.33 percent to 15.375 percent of book premiums; and

--a revised expense allowance of 30 percent of the company's book premium for administrative, operating, and claim adjustment expenses plus direct limited reimbursement for a portion of state premium taxes paid by a reinsured company.

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[5]In the context of this report, "cede" is a process whereby the reinsured companies relinquish or transfer a portion of their business (premiums and liability for losses) to FCIC. The objective of this arrangement is to permit a company to better manage its risks by allowing it to transfer some of the risk to the FCIC. This feature was not included in prior reinsurance agreements.

Coverage requirements

Under prior years' agreements, reinsured companies could selectively write insurance. They did not have to provide insurance to all eligibile producers or crops or to a particular area, county, or state. And, as noted previously, the reinsured companies could further limit their coverage by choosing to establish a dollar limit for a county or state in which they shared in the total gain or loss. Any insurance provided above the limit prescribed by the reinsured company was transferred to FCIC. These conditions change, however, under the 1986 agreement.

Under the 1986 agreement, reinsured companies are required to provide insurance for any eligible producer in a state where the company already offers insurance for that particular crop. Further, under the 1986 agreement, a company can cede no more than 57 percent of its business to FCIC. These ceding provisions are discussed further in the following section of this appendix.

Reinsurance cessions

The 1986 agreement includes three provisions under which the reinsured companies can cede or relinquish to FCIC a portion of their business (premiums and liability for losses). These provisions go beyond the reinsurance agreements of prior years in that they permit reinsured companies to transfer business to FCIC for which they do not wish to retain the liability for losses. Under prior agreements, FCIC did not require any ceding; rather, it allowed the reinsured companies to determine whether and when business should be relinquished to FCIC. Each of the three new provisions are discussed below.

First, there is a provision that reinsured companies may cede up to 95 percent of the premium and liability for losses for specific insurance policies to FCIC. The specific policies are designated by the reinsured companies. This is called the Assigned Risk provision of the agreement. Since FCIC requires that the companies offer insurance to all eligible producers regardless of whether they are poor risks, this provision was included in the agreement to help the companies deal with this new coverage requirement. The policies designated under this provision cannot exceed 10 percent of a company's total business, and must be designated by the companies within 15 days after the applicable sales closing date.

A second provision, called the Quota Share provision, requires a reinsured company to cede 5 percent of its premium and liability for losses to FCIC. Policies ceded under the Assigned Risk provision of the agreement, however, cannot be ceded under this provision. The purpose of the Quota Share provision is to provide FCIC with business from all reinsured companies for use in exchanging business under the new Portfolio Exchange provision described in the following section. The provision allows reinsured companies whose business is concentrated in a few states to exchange portfolios with FCIC, thereby spreading their risks to all states where FCIC provides insurance.

The third provision, called the Surplus Share provision, allows a reinsured company to cede an additional portion of its insurance premiums and liabilities to FCIC. Any liabilities and premiums on the business reinsured are ceded to FCIC after all Quota Share or Assigned Risk cessions have been made. If a company chooses to cede additional liabilities and premiums to FCIC under the Surplus Share provision, it designates a dollar amount of premium by state for either

--each crop it plans to insure in the state,

--each county in the state,

--the state as a whole, or

--a combination of either the crops and the state as a whole or the counties and state as a whole.

The company makes its designations under this provision in its plan of operation, which must be approved by FCIC before the company can sell crop insurance. The company cedes 80 percent of its premium and associated liability above the amount(s) designated to FCIC under one of the options listed above. However, the total liability ceded to FCIC as Assigned Risk, Quota Share, and Surplus Share reinsurance cannot be more than 57 percent of a company's total business.

Portfolio exchanges

Another difference between the 1986 agreement and prior agreements is a feature called the Portfolio Exchange provision. As noted previously, under this provision a reinsured company with business concentrated in three or fewer states may exchange a portion of its business (portfolio) with FCIC. The exchange of portfolios allows a reinsured company to spread a portion of its risk concentrated in a few states to all states where FCIC provides reinsurance. It also allows a reinsured company greater utilization of another provision of the agreement which limits the amount of losses a reinsured company can have in individual states. This loss limitation provision--called the State Stop Loss provision--is discussed later in this appendix.

Under the 1986 agreement, the amount of business a reinsured company may exchange under this provision is limited by the extent its business was concentrated in three or fewer states the previous year. If at least 50 percent of its business was concentrated in one state, the company may exchange an amount equal to the percentage of its business written in that state the previous year less 25 percent. For example, if a reinsured company had 80 percent of its business in one state in crop year 1985, it may exchange 55 percent of its business in that state with the FCIC in 1986. If at least 60 percent of its business was concentrated in two states, the company may exchange an amount equal to the percentage of its business written in those states the previous year less 50 percent. If at least 75 percent of its business was concentrated in three states, the company may exchange an amount equal to the percentage of its business written in those states the previous year less 65 percent.

If the portfolios are exchanged, the company will cede the prescribed percentage of its premiums and associated liability to FCIC but only after any Assigned Risk, Quota Share, and Surplus Share reinsurance cessions are made. Further, any business ceded under the Assigned Risk, Quota Share, and Surplus Share provisions cannot be used by a reinsured company in a portfolio exchange. In exchange for the business ceded to it, FCIC will return to the company an equal amount of premiums and liability from the business ceded to it by other reinsured companies under the Quota Share provision of the reinsurance agreement. If the pool of business FCIC acquired under the Quota Share provision is not large enough to accommodate all portfolio exchanges, the portfolio amounts to be exchanged will be reduced on a pro rata basis until the pool is sufficient to meet the exchange needs.

Gain and loss formula

The 1986 agreement provides for increasing a reinsured company's maximum share of underwriting gains and losses from the 1985 share of 11.33 percent of book premiums to 15.375 percent of book premiums. Under the 1986 agreement, the maximum company gain occurs only when there are no loss claims paid on the portion of the company's business not ceded to FCIC. The maximum company loss occurs when the company's loss ratio reaches 565 (where losses exceed 465 percent of premiums). A company does not share in any gain or loss resulting from that portion of business ceded to FCIC.

Determining the specific distribution of losses among reinsured companies and FCIC is a complex process governed by two key provisions of the 1986 agreement. These two provisions were not included in prior agreements; they are called the State Stop Loss provision and the National Stop Loss provision. As their names imply, both provisions serve to limit the amount of losses reinsured companies can experience.

Under the State Stop Loss provision, a reinsured company's gain or loss experience is first considered on a state-by-state basis. In practice, this means that FCIC pays 80 percent of losses between 100 and 200 percent of premiums in each state and 90 percent of any losses exceeding 200 percent.

If, after applying the State Stop Loss provisions and combining a company's gains and losses among states, there is a net underwriting loss, the distribution of the net underwriting loss between a company and FCIC is further governed by the application of a National Stop Loss provision.

The National Stop Loss provision is applied in three tiers. Under the first tier, FCIC pays 50 percent of the first 5 percent of total losses remaining for all states combined. Under the second tier, FCIC pays 75 percent of the losses between 5 percent and 56.5 percent of the total losses for all states. And under the third tier, FCIC pays 100 percent of total losses above 56.5 percent for all states.

The following hypothetical example demonstrates how the State and National Stop Loss provisions work in computing a company's maximum share of losses. Under the 1986 agreement a company's maximum loss occurs when losses exceed premiums by 465 percent.

Table 1

Distribution of Losses Under the 1986 Standard Reinsurance Agreement --State Stop Loss Provision--

State Stop Loss criteria	Company losses in excess of premiums (percent)	Losses retained by Company Percent	Company Loss	FCIC Percent	FCIC Loss
1. FCIC pays 80% of first 100% of losses in excess of premiums	100	20	20.0	80	80.0
2. FCIC pays 90% of losses in excess of 100% of premiums	365	10	36.5	90	328.5
Total	465		56.5		408.5

As table 1 shows, a company having total losses of 465 percent more than premiums would be liable for losses equal to 56.5 percent of premiums. FCIC would be liable for the balance of the total loss or 408.5 percent of premiums. However, the company's retained losses of 56.5 percent of premiums are then applied to the National Stop Loss provision. Application of the National Stop Loss provision further divides the loss liabilities between the company and FCIC, as the following table shows.

Table 2

Distribution of Losses Under the 1986
Standard Reinsurance Agreement
--National Stop Loss Provisions--

National Stop Loss criteria	Breakdown of losses using National Stop Loss criteria[a]	Company's liability: Company's share of payment	Company's liability: Company's share of losses	FCIC's liability: FCIC's share of payment	FCIC's liability: FCIC's share of losses
	(percent)				
1. FCIC pays 50% of first 5% of Losses (company pays remaining 50%)	5	50	2.500	50	2.500
2. FCIC pays 75% of losses between 5% and 56.5% (company pays remaining 25%)	51.5	25	12.875	75	38.625
3. FCIC pays 100% of losses above 56.5%	0	0	0	100	0
Total	56.5		15.375		41.125

[a]The breakdown of this column is based on the 56.5 percent figure from table 1. It represents the company's portion of loss liability after the application of the State Stop Loss provision.

APPENDIX I

Table 2 shows that after the National Stop Loss provision is applied, the company's maximum share of loss is reduced from 56.5 percent of losses above premiums to 15.375 percent. Correspondingly, FCIC's share of the loss is increased from 408.5 percent after the application of the State Stop Loss provisions to 449.625 percent (408.5 from table 1 plus 41.125 from table 2). The total company liability of 15.375 percent plus the total FCIC liability of 449.625 percent equals the total loss of 465 percent.

Gains under the 1986 reinsurance agreement are handled differently from losses. If, after combining a company's gains and losses among states, there is a net underwriting gain, the gain is shared between the company and FCIC in the following prescribed manner.

Table 3

Distribution of Gains Under the 1986 Standard Reinsurance Agreement

Company's loss ratio (% of premiums)	Maximum possible gain	Distribution of gain: Reinsured company Percent[a]	Reinsured company Gain	FCIC Percent	FCIC Gain
95 to 100	5	100	5.000	0.0	0.00
85 to 95	10	40.0	4.000	60.0	6.00
0 to 85	85	7.5	6.375	92.5	78.625
Total	100		15.375		84.625

[a]The 1986 agreement provides that reinsured companies receive 100 percent of any gain above a loss ratio of 95 percent; 40 percent of any gain between a loss ratio of 85 to 95 percent; and, 7.5 percent of any gain below a loss ratio of 85 percent.

As the table shows, the maximum gain a company can realize under the 1986 agreement is 15.375 percent of a company's business. Under the 1985 agreement, the maximum gain was 11.33 percent. To highlight the differences between the 1986 agreement and prior agreements, the following section of the report compares the gain and loss distribution for each year.

Comparison of gain and loss distribution for all Standard Reinsurance Agreements

Table 4 compares the gain and loss distributions to a reinsured company and to FCIC under the 1986 agreement and under all prior agreements. The comparison is based on a range of loss ratios starting from a loss ratio of zero--a gain situation where all the premiums are received and there are no claims made against a policy--up to a loss ratio of 565--a loss situation where there are $565 in insurance claims for each $100 of premiums paid. A loss ratio of 100 means that claims and premiums are equal and there is no gain or loss experienced.

Table 4

Comparison of Gain and Loss Distributions for All Standard Reinsurance Agreements

Loss ratio	1981[b] Company	1981[b] FCIC	1982[b] Company	1982[b] FCIC	1983-1985[b] Company	1983-1985[b] FCIC	1986 (one-state company[c]) Company	1986 (one-state company[c]) FCIC
	Numbers represent a percentage of premiums[a]							
00	5	95	8	92	11.33	88.67	15.375	84.675
40	5	55	8	52	11.33	48.67	12.375	47.625
75	5	20	8	17	11.33	13.67	9.75	15.25
90	5	5	3.33	6.67	6.67	3.33	7	3
95	5	0	1.67	3.33	5	0	5	0
100	0	0	0	0	4.25	(4.25)	0	0
110	(5.25)	(4.75)	(1)	(9)	2.75	(12.75)	(1)	(9)
128.33	(6.17)	(22.16)	(2.83)	(25.5)	0	(28.33)	(2.67)	(25.66)
160	(7.5)	(52.5)	(6)	(54)	(4)	(56)	(4.25)	(55.75)
200	(8.5)[d]	(91.5)	(8)[d]	(92)	(8)	(92)	(6.25)	(93.75)
300	(8.5)[d]	(191.5)	(8)[d]	(192)	(9)	(191)	(8.75)	(191.25)
533.33	(8.5)[d]	(424.83)	(8)[d]	(425.33)	(11.33)[d]	(422)	(14.58)	(418.75)
565	(8.5)[d]	(456.5)	(8)[d]	(457)	(11.33)[d]	(453.67)	(15.375)[d]	(449.625)

[a]Parentheses indicate a loss.

[b]For crop years 1981 through 1985, the reinsurance agreements provided that a further distribution of the gain would be made if a positive balance existed in the company's account after a 5-year period. This is called a 5-year gain provision.

[c]This assumption is used to keep the comparison consistent with prior years' agreements which had no State or National Stop Loss provisions.

[d]Indicates maximum company loss under each Standard Reinsurance Agreement and the loss ratio at which the maximum company loss occurs.

Table 5

Comparison of Expense Allowance Reimbursement Rates Under Each Standard Reinsurance Agreement

Expense items	Reimbursement rate as a percent of premiums 1981-84	1985[c]	1986
Administrative expenses	22	24[d]	30[e]
Reimbursement for new business	5	-	-
Loss adjustment expenses:			
Indirect loss expenses	4	4	-
Direct loss expenses[a]	3	Varies[b]	-
State premium tax	-	-	2[f]

[a]Computed on indemnities paid rather than on premiums.

[b]Percent paid was based on a sliding scale of 3 percent to 0 percent depending on the company's loss ratio for the crop year.

[c]The revised rates established for 1985 were optional. Accordingly, the reinsured companies had the option of using the 1985 rates or the rates under the prior reinsurance agreements.

[d]Established single rate to cover both carryover and new business. Under previous agreements there was a separate reimbursement rate for new business.

[e]Established a single rate covering all administrative and loss adjustment expenses.

[f]FCIC estimates the state premium tax will average 2 percent nationwide.

OVERALL FINANCIAL COMPARISON OF STANDARD REINSURANCE AGREEMENTS: 1986 VERSUS PRIOR YEARS

As the previous sections of this appendix demonstrate, the amount of compensation reinsured companies could receive under the prior agreements and the 1986 agreement varies. For example, the reimbursement rates for administrative and operating expenses are different, as are the gain/loss formulas. Because of all of the variables that come into play in determining the total amount of compensation a reinsured company would receive under the various agreements, we developed the following table to show how a company would fare under each reinsurance agreement. The table is based on the provisions in each reinsurance agreement since 1981. All figures in the table are expressed as a percentage of premium dollars using a range of loss ratios.

Table 6

Comparison of Total Compensation to Reinsured Companies
Under Each Reinsurance Agreement
(Percentage of Premium Dollar)

Compensation items	Loss ratios							
	00	75	90	100	125	200	533.33	565
1981 agreement-(CY 81)								
Administrative expenses[a]	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5
Claims adjustment expenses	4.0	6.25	6.7	7.0	7.75	10.0	20.0	20.95
Gain and (loss) distribution	5.0	5.0	5.0	-	(6.0)	(8.5)	(8.5)	(8.5)
5-year gain[b]	5.0	4.0	1.0	-	-	-	-	-
Total	38.5	39.75	37.2	31.5	26.25	26.0	36.0	36.95
1982 agreement-(CY 82)								
Administrative expenses[a]	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5
Claims adjustment expenses	4.0	6.25	6.7	7.0	7.75	10.0	20.0	20.95
Gain and (loss) distribution	8.0	8.0	3.33	-	(2.25)	(8.0)	(8.0)	(8.0)
5-year gain[b]	5.0	3.4	1.33	-	-	-	-	-
Total	41.5	42.15	35.86	31.5	30.0	26.5	36.5	37.45
1983 agreement-(CY 83-84)								
Administrative expenses[a]	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5
Claims adjustment expenses	4.0	6.25	6.7	7.0	7.75	10.0	20.0	20.95
Gain and (loss) distribution	11.33	11.33	6.67	4.25	0.5	(8.0)	(11.33)	(11.33)
5-year gain[b]	5.0	2.73	0.67	-	-	-	-	-
Total	44.83	44.81	38.54	35.75	32.75	26.5	33.17	34.12
1985 agreement-(CY-85)[c]								
Administrative expenses[a]	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0
Claims adjustment expenses	4.0	6.25	6.7	7.0	7.625	9.5	13.0	13.0
Gain and (loss) distribution	11.33	11.33	6.67	4.25	0.5	(8.0)	(11.33)	(11.33)
5-year gain[b]	5.0	2.73	0.67	-	-	-	-	-
Total	44.33	44.31	38.04	35.25	32.125	25.5	25.67	25.67
1986 agreement-(CY 86)[d]								
Administrative expenses[e]	32.0	32.0	32.0	32.0	32.0	32.0	32.0	32.0
Claims adjustment expenses	-	-	-	-	-	-	-	-
Gain and (loss) distribution	15.375	9.75	7.0	-	(2.5)	(6.25)	(14.58)	(15.375)
5-year gain[f]	-	-	-	-	-	-	-	-
Total	47.375	41.75	39.0	32.0	29.5	25.75	17.42	16.625

[a]For these years the administrative expenses varied depending on whether a company was being reimbursed for new or carryover business. Because of this, assumptions had to be made as to the mix of new and carryover business so that a single figure could be used in estimating the reimbursement rate. Accordingly, we used the same rate that FCIC uses in its estimates--24.5 percent of premiums. This rate assumes that premiums from new business equal premiums from carryover business.

[b]The 5-year gain provision was in all reinsurance agreements through 1985. Essentially, it provided for any cumulative net gains after 5 years to be further distributed among the reinsured companies and FCIC. This distribution is beyond any distribution made under the annual gain/loss formula contained in the respective agreements.

[c]Although the rates for 1985 were optional, companies accepting the revised rate had written about 90 percent of the total business retained by companies in 1984.

[d]The computation of the company's share of the gains and losses under the 1986 agreement is based on the assumption that a company operates in only one state.

[e]The administrative expense figure represents the flat 30 percent reimbursement rate plus 2 percent for the state premium tax subsidy. The 2 percent figure is a nationwide average estimate provided by FCIC.

[f]There is no 5-year gain provision in the 1986 agreement.

INFORMATION ON

FCIC's OVERALL FINANCIAL CONDITION

FCIC receives funds from three sources--capital stock subscriptions from the U.S. Treasury, premium income from producers, and appropriations for federal premium subsidies and administrative and operating expenses. The administrative and operating appropriation covers items such as employee salaries and fringe benefits, premium subsidies paid by FCIC, cost of adjusting losses, and payments to reinsured companies for selling and servicing policies. The program fund, which includes premium income[1] and capital stock, is used only to pay producers' claims and any gains distributed to reinsured companies.

Prior to 1980, FCIC operated as a small scale insurance program. However, the Federal Crop Insurance Act of 1980 reorganized and redirected the program. The act expanded the FCIC's insurance program by requiring that crop insurance be made available to producers anywhere in the nation--prior to the 1980 act there was no such requirement. The 1980 act also provided that insurance premiums would be subsidized by FCIC and that the private sector would be used to the maximum extent possible to sell and service crop insurance. Further, the 1980 act called for an actuarially sound insurance program that would protect producers against essentially all unavoidable risks and, at the same time, required that higher amounts of insurance coverage be made available.

To carry out its new responsibilities, the 1980 act also authorized FCIC $500 million in capital stock from the U.S. Treasury. The capital stock was to provide FCIC with working capital as well as a reserve to cover losses when premium income was insufficient.

The FCIC's financial situation has deteriorated due to high annual insurance losses since 1980. This situation exists essentially because premiums charged have been too low and a series of disasterous weather has plagued certain of the crops covered by the FCIC insurance program. Table 8 shows the extent of the losses FCIC has experienced (where indemnities exceeded premiums) in each year since 1980.

[1] Includes the premium subsidy which is transferred from the administrative fund.

Table 7

Premiums, Indemnities, and Loss Ratios by Crop Year

	Crop year				
	1980	1981	1982	1983[b]	1984[b]
Premiums (millions)	$157.1	$376.8[a]	$393.1[a]	$290.9[a]	$440.1[a]
Indemnities (millions)	$356.0	$406.7	$517.9	$599.9	$637.7
Loss ratio	2.27	1.08	1.32	2.06	1.45

[a]Includes federal premium subsidy

[b]Latest available data as of May 1985.

Due to these underwriting losses the FCIC's capital stock is nearly depleted--$50 million in capital stock remained at the beginning of fiscal year 1985--and premium income and appropriations have not been sufficient to cover crop losses. These underwriting losses have continued into fiscal year 1985. Because of this the program fund dropped from about $350 million in September 1984 to about $1.4 million by July 17, 1985.

On March 8, 1985, the FCIC, in recognition of its deteriorating financial condition, proposed three different means of obtaining needed additional funding that would permit the continued payment of claims:

--Sell the remaining $50 million of authorized capital stock.

--Borrow $350 million from the U.S. Treasury.

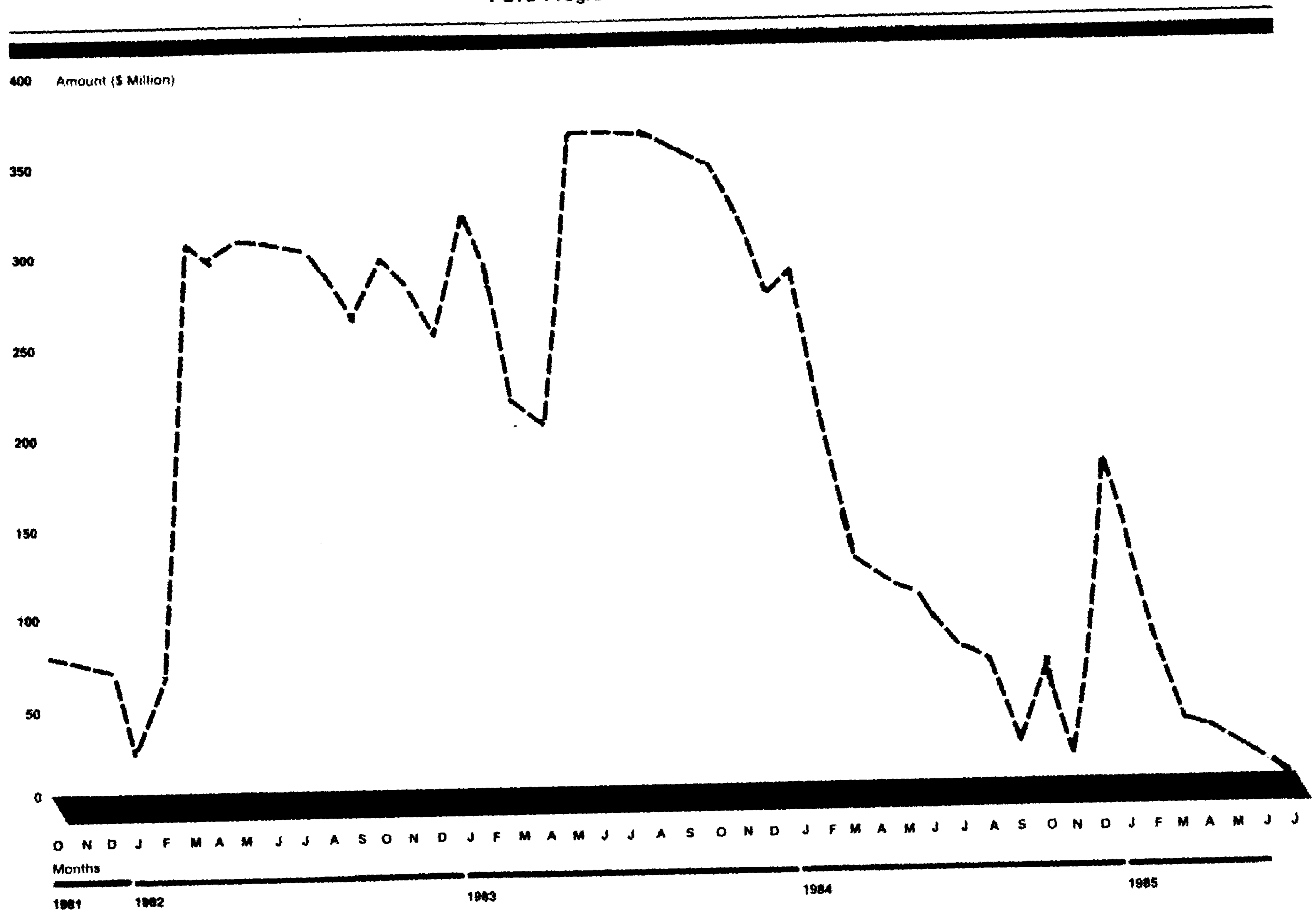
--Transfer $50 million from the administrative fund.

The only action taken so far has been the transfer of $50 million from the administrative fund to the program fund on March 26, 1985.

With only $1.4 million in its program fund on July 17, 1985, the Secretary of Agriculture announced that the FCIC was suspending payments on insured losses. According to FCIC officials, without a supplemental appropriation to the program fund this fiscal year, the FCIC will pay only claims that can be covered by premium payments. Since the FCIC transferred money from its administrative fund on March 26, 1985, to pay insurance claims, it is also short money to meet administrative expenses, including payroll. On July 22, 1985, the manager of the FCIC announced that unless a supplemental appropriation was passed the administrative fund would be depleted on or about August 25, 1985.

In its supplemental request to the Congress, FCIC is requesting authority to use the $50 million in remaining capital stock to pay back the transfer of $50 million from the administrative fund. In addition, it is asking for $113 million to cover projected 1985 losses. The $113 million is FCIC's estimate of what is needed to pay anticipated insurance claims through the end of fiscal year 1985. (Figure 1 graphically portrays the FCIC's cash postion month-by-month from October 1981 to July 1985.)

Figure 1
FCIC Program Fund Cash Position



Source: FCIC.

APPENDIX I

Expense allowances

The final significant difference we noted between the 1986 agreement and prior agreements involves the expense allowances provided to reinsured companies. The 1986 agreement provides that FCIC will pay a reinsured company an expense allowance equal to 30 percent of the total book premium--the premium paid by the producer plus the premium subsidy paid by FCIC--on all policies. This allowance is to reimburse the companies for administrative, operating, and loss determination expenses incurred in selling, servicing, and adjusting the losses on the crop insurance policies sold by the company. In addition, under the 1986 agreement FCIC will reimburse the companies for premium taxes paid to state governments for insurance policies sold in those states up to certain prescribed limits. The limits are geared to the respective states' tax rate for other kinds of related insurance. Accordingly, the reimbursement rates vary from state to state. An FCIC official estimates, however, that the state taxes on premiums will average about 2 percent of premiums nationwide. The premium tax is an expense that the companies have incurred in the past, that they have not been reimbursed for, and that has not been specifically included in prior years' agreements. The expense allowance and premium tax reimbursements are paid on all crop insurance policies sold regardless of whether a portion of such sales is ceded to FCIC.

The following table compares the expense allowance rates provided the reinsured companies by the different reinsurance agreements, including the 1986 agreement.