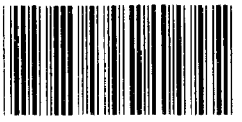
131061

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


131061

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 a.m.
SEPTEMBER 23, 1986

STATEMENT OF
BRIAN P. CROWLEY, SENIOR ASSOCIATE DIRECTOR
RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT
HOUSE COMMITTEE ON AGRICULTURE

ON

PRELIMINARY RESULTS OF GAO'S REVIEW OF THE DEPARTMENT OF AGRICULTURE'S FEDERAL CROP INSURANCE PROGAM

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its oversight of the Federal Crop Insurance Corporation (FCIC) in implementing the expanded crop insurance program called for by the Federal Crop Insurance Act of 1980 (Public Law 96-365).

As a result of the 1980 act, FCIC expanded its insurance coverage from 27 crops in about 1,700 counties in 1980 to about 40 crops in about 3,000 counties currently. During this period, however, FCIC experienced serious financial difficulties. During fiscal years 1981-85 insurance claims (indemnities) exceeded premiums by $877 million. Administrative and operating costs increased from $1.43 per insured acre in crop year 1980 to $4.15

036764 131061

per insured acre in crop year 1985. Because of its financial difficulties, FCIC had to suspend insurance payments to farmers 4 times in 1985 and 1986. Concerned that major decisions made by FCIC management may have been based on inadequate data and analysis, you and several other Members asked us to review the data and analyses that supported certain key decisions.

Our overall objective, therefore, was to determine whether management decisions were based on complete, accurate, and up-to-date information and whether the supporting analyses were adequate. My testimony today presents the preliminary results of our work to date. Our conclusions are tentative and will be further developed as we continue our internal review process and obtain agency comments. We plan to issue a written report detailing the results of our work in the near future.

In summary, FCIC has made progress in improving the actuarial soundness of its program, but we found problems in each area you asked us to review. These areas covered FCIC's bases for:

-- forecasting annual program activity,

-- proposing to rely on reinsurance as the primary delivery system,

-- establishing compensation rates paid to master marketers and reinsured companies,

-- sharing of insurance gains and losses between FCIC and reinsured companies,

-- improving the actuarial soundness of the program,

-- moving to actual production history as a basis for establishing farmers' crop yields,

-- deciding that all farms owned by one policyholder be treated as a single farm, and

-- assuring that FCIC's major decisions conform to legislative requirements.

In reviewing the above matters, we found problems ranging from decisions being made on the basis of incomplete and inaccurate data to decisions being made without fully complying with legislative requirements. The results of our review of each of the specific matters we reviewed are as follows.

FCIC's FORECASTS OF ANNUAL PROGRAM ACTIVITY

Since the program expanded in 1981, through fiscal year 1985, FCIC's indemnities exceeded its premium income by about $877 million. During this period, however, FCIC forecasted a gross income[1] of about $290 million, a difference between the budget forecast and actual experience of nearly $1.2 billion.

To forecast premium income, FCIC requires data on two key factors--(1) the number of acres that will be insured and (2) the average premium to be charged per acre. Multiplying these two factors provides FCIC's forecast of premium income. These factors have been determined largely on the basis of the Manager's judgment. Because these forecasting decisions are made

---

[1]For the purpose of this testimony gross income or loss is defined as the difference between premium income and indemnities.

by the Manager based largely on meetings with his staff rather than on documented quantitative data and analysis, we could not determine the specific bases for the decisions that were made and the validity of assumptions that underlie these decisions. The Manager told us that he considers historical data in making his forecasts; however, participation has been consistently overstated. In fact, forecasted premium income has averaged 33 percent less than actual for fiscal years 1981-85. Also, although actual premium income for fiscal years 1981-85 grew by only about 14 percent and never exceeded $440 million in any one year, FCIC's forecasts of premium income presented to the Department for fiscal years 1986 and 1987 were $760 million and $700 million, respectively, well in excess of historical trends.

On the other side of the equation, FCIC's indemnity forecast is derived simply by multiplying forecasted premium income by 90 percent. FCIC uses 90 percent because its goal is to achieve a loss ratio of 0.9; that is, for every dollar of premium income, 90 cents will be paid out in indemnities. For fiscal years 1981-85 indemnities exceeded premiums each year, with loss ratios ranging from 1.07 to 2.06. Appendix I to my statement shows a year-by-year comparison of FCIC forecasts with actuals. Because FCIC's indemnity forecasts are not guided by actual loss experience, but by a management goal of 0.9, FCIC's budget presentations have consistently shown a gain despite losses in each of the first 5 years of the expanded program.

FCIC has had to fund a portion of these losses by requesting supplemental appropriations, borrowing from the Treasury, exhausting its capital stock, and using funds appropriated for other purposes. Some of these funding actions bypass the normal appropriations process. This, in our opinion, hampers the effectiveness of the Congress' budget oversight.

To fund program losses, FCIC

-- obtained $250 million from the Commodity Credit Corporation (CCC) in fiscal year 1981 and $138 million in 1986 (as of May 13, 1986),

-- borrowed $113 million from the U.S. Treasury,

-- issued and sold its entire $500 million worth of capital stock,

-- used $100 million of unearned premium subsidy appropriations, and

-- transferred $50 million from FCIC's administrative and operating expenses account to its Insurance Fund (this was subsequently transferred back).

We compared FCIC's forecasting process with that used by the Federal Insurance Administration (FIA), which administers the National Flood Insurance Program. FIA uses a more systematic and objective approach to forecasting premium income and indemnities.

FIA's forecasts of premium income and indemnities are done by staff who use a sophisticated computerized model involving such things as simulations, sales and indemnity trend analysis,

and regression analysis, including historical experience on individual policies.

Although the FIA Administrator generally approves the staff's forecasts, he does make program changes both to spur policy sales and to reduce the amount of indemnities paid. These program changes are then considered in developing revised forecasts. The key point here is that the FIA Administrator uses forecasts developed by the FIA staff as a tool in making decisions about program changes that might be needed to meet established goals and objectives. This contrasts with the approach used by FCIC management where the bases for forecasts were not documented and the forecasts were based on the Manager's judgment and existing program goals.

FIA's forecasting methods have been relatively accurate. For fiscal years 1981-85, FIA forecasted premium income of $1.66 billion and indemnities of $1.68 billion compared with actual premium income and indemnities of $1.53 billion and $1.26 billion, respectively.

- - - - -

Although we recognize the difficulty of FCIC's forecasting task, the record shows that FCIC has developed a consistent pattern of overestimating premium income and understating losses. To help improve the reliability of FCIC's forecasting, FCIC should move toward a forecasting process that relies on, among other things, historical trends and on quantitative data and analysis.

FCIC'S PROPOSAL TO SELL CROP INSURANCE MAINLY THROUGH REINSURED COMPANIES

On May 22, 1985, FCIC announced that it was proposing to amend its regulations to provide crop insurance mainly through private, reinsured companies. In crop year 1984 about 60 percent of FCIC's insurance was provided through reinsured companies and the remainder through master marketers. Under its proposal FCIC would have discontinued sales through master marketers. FCIC estimated that implementing its proposal would save $18.3 million in fiscal year 1986 and $13.3 million in 1987.

FCIC did not determine the impact that its decision would have on its ability to assure the expanded availability of insurance to farmers, as intended by the 1980 act. FCIC subsequently recognized this problem and in January 1986 announced that it was rescinding its proposal because, among other things, it could not assure that insurance would be available to all farmers. At your request we reviewed the basis for FCIC's proposal and found that the decision was not based on a complete analysis.

In addition to not determining impact on insurance availability, FCIC did not (1) as required by the Office of Management and Budget (OMB), measure the cost of the proposed system against an efficient dual-delivery system that used both reinsured companies and master marketers or (2) consider all costs in estimating savings from implementing its proposal. Further, FCIC did not determine the impact of its proposal on farmer participation and the program's actuarial soundness. It

is also continuing to encourage reinsurance as its main delivery system.

In making its cost analysis, FCIC compared its proposed reinsurance system with its existing delivery system, which it recognized was inefficient. Because it did not adjust the existing system's costs to recognize that the system could be operated more efficiently, FCIC overstated the savings that its proposed reinsurance system could achieve.

In its May 1985 announcement, FCIC said that the master marketer portion of the existing delivery system was handling only about half the business it was designed to handle. Yet in making its cost comparisons, FCIC used the costs associated with the inefficient system rather than reducing those costs to recognize that the existing system could be more efficient.

To obtain an estimate of what the impact of this might be on the savings amount, we assumed a somewhat more efficient system and recalculated the savings amount. The results showed FCIC's savings estimate of $18.3 million would have been reduced to $5.5 million.

In estimating its savings, FCIC did not consider or did not adequately consider certain costs. Our review showed that employee termination, relocation, and associated costs were understated by about $8.5 million. Further, FCIC's study did not include such costs as employee retirement and office closing costs and the cost of the delivery system needed to serve farmers unable to obtain insurance from reinsured companies. Had FCIC

properly considered all cost factors and conducted the study in accordance with existing OMB guidance, the results would likely have shown little, if any, savings.

Impact of Proposal on Actuarial Soundness and Program Participation Not Adequately Determined

Two major objectives of the 1980 act are to (1) achieve the broadest possible farmer participation in the program and (2) operate the program on an actuarially sound basis. We did not find any evidence that FCIC determined the impact of its proposal on program participation or on the program's actuarial soundness. Because reinsured companies share in insurance gains and losses with FCIC and master marketers do not, increased reinsurance sales could have significant actuarial implications, particularly if FCIC is to build a reserve for unforeseen losses. Also, because the actuarial soundness of an insurance program depends on spreading risks among as many participants as possible, the impact of FCIC's proposal on participation could be a significant factor.

FCIC actions to encourage reinsurance

FCIC has taken both direct and indirect action to increase the percentage of sales handled by reinsured companies and decrease the percentage handled by master marketers. In March 1985, for example, FCIC announced that it was considering terminating master marketer sales. FCIC anticipated that this announcement would encourage policyholders having contracts with master marketers to transfer their policies. Moreover, FCIC

delayed the signing of the master marketer sales agreement by about 4 months; notified master marketers and their agents that if they did not transfer their policies to a reinsured company, FCIC would transfer it for them; and extended the policy transfer date by 3 weeks.

FCIC's actions resulted in the proportion of master marketer sales transferred to reinsured companies increasing by 11 percentage points in 1985. FCIC projects that 98 percent of its 1987 sales will be through reinsured companies.

- - - - -

In our opinion, the 1980 act neither mandates nor precludes an all-reinsurance program. However, there appears to be a difference between FCIC and congressional committees regarding the method of delivering crop insurance to farmers. Although the Department of Agriculture favors an all-reinsurance program, congressional appropriation and legislative committees have favored a system which relies on both master marketers and reinsured companies. For example, the House Committee on Agriculture, in its report on the Food Security Act of 1985 (H. Rept. 99-271), stated that, although the act provides for a reinsurance program, "it should not be interpreted by the FCIC that reinsured companies be the only method by which crop insurance is sold under the Act."

In our view, FCIC's continued movement to virtually an all (98 percent of sales) reinsured delivery system may not be justified based on (1) our assessment of FCIC's cost analysis,

(2) uncertainties about whether such a system will assure the expanded availability of insurance to farmers as intended by the 1980 act, and (3) the potential impact an all-reinsurance system could have on the actuarial soundness of the program.

COMPENSATION RATES

In 1984 we reported that the compensation rates paid master marketers and reinsured companies needed to be reevaluated. According to FCIC studies since that time, current compensation levels are comparable to those in other sectors of the insurance industry. However, the rates were not established in accordance with the provisions of the 1980 act which directs that the rates be based on FCIC's cost for providing similar services.

Problems Reported on in March 1984

In March 1984 we reported two major problems with the way FCIC established the rates for compensating reinsured companies for selling, servicing, and adjusting losses on crop insurance and master marketers for sales and service.[2] First, FCIC did not adjust the rates for expected premium increases resulting from the implementation of the 1980 act. Due to changes in the scope and type of insurance called for by the 1980 act--including different and higher levels of protection--and other reasons, premium rates have risen steadily. Because compensation rates are based on a percentage of premiums, the amount of compensation likewise increased. We reported that FCIC should have adjusted

---

[2]More Attention Needed in Key Areas of the Expanded Crop Insurance Program (GAO/RCED-84-65, March 14, 1984).

the compensation rates to recognize the increased compensation that would occur simply from the act's passage.

In addition, the compensation rates for reinsured companies were not established in accordance with the 1980 act's provisions. The act requires that reinsured companies be compensated on the basis of costs FCIC would have incurred for providing similar services. In setting the rates, however, FCIC included inappropriate cost data. For example, FCIC included costs for certain actuarial services that FCIC performs for the reinsured companies and costs for claims adjustment activities for which reinsured companies were, at the time, paid separately. We concluded that compensation rates established for reinsured companies were about 6 percentage points higher than warranted by the act.

FCIC Basis for Establishing Current Rates for Reinsured Companies

In response to a recommendation in our March 1984 report, FCIC contracted with two private firms to determine if the compensation to reinsured companies was fair and equitable. One firm reviewed four companies and the other reviewed seven. The studies' results were not conclusive, however, because the companies did not segregate costs associated with FCIC business.

Nevertheless, as one of the firms recommended, FCIC decided to base the compensation rate solely as a percent of premium income and to reimburse the companies for state premium taxes. The reimbursement of state taxes is designed to encourage companies to expand into states with high taxes for out-of-state

companies. For reasons I will discuss later, we question whether FCIC is authorized to reimburse companies for state premium taxes.

FCIC's negotiations with reinsured companies on the 1986 agreement led to a compensation rate of 30 percent of premiums plus reimbursement for state premium taxes which it estimated would average 2 percent of premiums. FCIC's evaluation of the reasonableness of this rate showed that it was generally lower than the sales, service, and loss adjustment costs of commercial insurance companies.

FCIC Basis for Establishing Current Rates for Master Marketers

The 1985 agreement with master marketers set the current compensation rate for master marketers at 15 percent of premiums. FCIC analyzed prior year premiums and compensation and determined that a rate of 14.6 percent with reductions for large policies would provide master marketers with compensation equivalent to what they were receiving. Subsequently, FCIC analyzed the sales costs of companies selling commercial insurance and this analysis showed that the 15 percent rate, without adjustment for large policies, was comparable to the sales costs of these companies and the 15 percent rate was approved by the FCIC Board of Directors.

- - - - -

The 1980 act prescribes that FCIC compensate reinsured companies on the basis of FCIC's costs to provide the same services. This requirement places FCIC in a dilemma. Its

studies show that its compensation rates are comparable to costs of other sectors of the industry. Also, reinsured companies are performing tasks that FCIC did not perform prior to the program's expansion. Based on the act's provision, FCIC's basis for setting rates was not adequate because it merely relied on prior compensation rates. Unless the act is amended, FCIC will have to devise a means of compensating reinsured companies based on its costs.

GAIN AND LOSS SHARING

Gains and losses on crop insurance sold by reinsured companies are shared by the companies and FCIC. Our analysis of the information FCIC had available to it in negotiating the standard reinsurance agreement for 1986 showed that FCIC had adequate data upon which to base decisions about the agreement's gain and loss provisions but that, overall, the provisions FCIC agreed to favored reinsured companies. This, in turn, adversely affects FCIC's ability to establish a reserve for unforeseen losses.

FCIC Had Adequate Information to Negotiate the 1986 Provisions

Before entering into negotiations with reinsured companies on the 1986 agreement, FCIC contracted with an actuarial firm to study the gain and loss provisions in effect at the time and make recommendations for improvement. The firm concluded that the gain and loss formula was biased in the reinsured companies' favor; however, it said that the bias may be appropriate given the companies' perception that premium rates were inadequate to

offset indemnities. The firm said that, nevertheless, the imbalance reduced FCIC's ability to establish a reserve and therefore suggested that FCIC include expected distributions of gains in setting premium rates. (Under current legislation FCIC is precluded from including the distribution of gains in setting premium rates.)

FCIC's former Manager told us that although FCIC attempted to make the gain and loss sharing provisions less favorable to reinsured companies, the proposals made to do this were unacceptable to the reinsured companies.

During the negotiations FCIC made at least six different proposals for revising the gain and loss sharing provisions that were included in the 1985 agreement. FCIC considered the actuarial firm's report in developing its first proposal and made cost analyses of the various proposals. FCIC made a detailed cost analysis of the proposal eventually agreed to by applying the proposal to total 1981-83 sales. This analysis showed that under the 1985 agreement the reinsured companies would have had a loss equal to 1.4 percent of premiums, while under the 1986 proposal eventually agreed to, the companies would have had a gain equal to 4.5 percent of premiums, a difference of 5.9 percentage points.

Our analysis compared the gain and loss sharing provisions of the 1985 and 1986 agreements by applying both to the reinsured companies' 1984 experience. Under the 1985 agreement the reinsured companies would have had to absorb about $600,000 of

the total loss of $79.9 million resulting from reinsurance sales, whereas under the 1986 provisions the companies would have had a gain of $6.1 million, a difference of $6.7 million, or about 3.5 percent of premium income.

1986 Agreement Favors Multi-state Companies

The 1983-85 agreements provided that reinsured companies would be paid for a "gain" even when their business resulted in a loss of up to 28-1/3 percent of premiums. Under the 1986 agreement this was changed so that a company operating in only one state will share in losses when that company's loss ratio is more than 1.0--in other words, when indemnities exceed premiums. This change will help reduce the extent to which reinsured companies operating within one state are favored. However, as illustrated in the table below, a reinsured company operating in more than one state can still be paid for a "gain" when, in fact, it had a loss on its policies. This is because of the stop loss provisions included in the 1986 agreement. (The stop loss provisions are explained in detail in App. III.)

Table 1: Comparison of Gain/Loss Sharing for Selected Multi-state Reinsured Companies' Under 1986 and Prior Agreements

Company	Loss on company's business	Distribution of gain (loss)			
		Prior agreements		1986 agreement	
		FCIC	Company	FCIC	Company
	(thousands)				
A	$2,328	($2,354)	$ 26	($ 2,700)	$ 372
B	2,283	(2,194)	(89)	(2,424)	141
C	2,129	(2,258)	129	(2,889)	760
D	10,211	(9,716)	(495)	(11,946)	1,735
E	9,081	(9,229)	148	(11,244)	2,163

Source: FCIC's 1984 sales and loss information adjusted by GAO to compare the gain/loss sharing provisions of the 1986 and prior agreements.

FCIC ACTIONS TO IMPROVE ACTUARIAL SOUNDNESS

As you requested, we followed up on the actions FCIC has taken to correct its actuarial problems, including those cited in our March 1984 report. We found that FCIC has taken a number of actions that when fully and properly implemented, should enhance the insurance program's actuarial soundness. These actions include developing a new computerized premium rate making model and developing insurance offers based on farmers' actual production histories. It will, however, be several years before these actions are fully implemented.

According to the 1980 act, FCIC was to establish an actuarially sound crop insurance program by administering the program so that premium income is sufficient to pay all claims and to establish a reserve for unforeseen losses. However, with indemnities exceeding premium income by about $877 million during

the program's first 5 years, the program has not operated in an actuarially sound manner.

In the past, we and others have criticized FCIC's actuarial practices. In our March 1984 report, we expressed concern that when FCIC expanded the program in response to the 1980 act, FCIC neglected its existing actuarial practices and delayed the development of needed actuarial reports.

As a result of our findings, as well as those of others, FCIC hired an actuarial consulting firm to design a new computerized model for establishing premium rates and to recommend improvements in FCIC's actuarial practices and management information systems.[3] FCIC developed and used the model for six crops in 1986, replaced its system of guaranteeing yields based on area averages with a system based on a farmer's own production history--called the Actual Production History (APH) Program, developed the required actuarial reports, and made other improvements recommended by the consulting firm.

Although the APH Program is now applied to nearly all crops, it will take several years for farmers to develop the production records needed to fully implement the program. It will also take several years to fully implement the new rate making model because (1) the model has to be validated through review and analysis of its application to the six crops, (2) the model has

---

[3]Although our report was issued in March 1984, we had apprised FCIC of our concerns about the crop insurance program's actuarial soundness by letter dated August 10, 1982.

to be revised before it can be applied to other crops, and (3) more and better data has to be accumulated at the county level before the model can be fully implemented, even for the six crops for which it has been used.

While FCIC's actions are large steps in the right direction, there is one point that we believe should be noted. In our March 1984 report, we said that FCIC had deferred using its statistically based procedures for periodically updating premium rates. FCIC has still not used these procedures but instead has used other procedures that rely heavily on judgmental decisions. For example, for the 1983, 1984, and 1985 crop years, FCIC developed tables that prescribed the amounts of premium increases or decreases. The primary basis for establishing the various rates was not recent loss experience, but the judgment of FCIC management. Until the APH Program and the new rate making model are fully implemented, management judgment will continue to be used to fix premium rates.

ACTUAL PRODUCTION HISTORY PROGRAM

A number of studies made prior to FCIC's decision to implement the Actual Production History Program recommended that FCIC replace its system of setting farmer-insured yields based on area averages with one based on farmers' individual production histories. Accordingly, FCIC had support that a production-history-based program was needed before it made its decision to implement the APH Program. However, FCIC did not fully comply with a provision of the 1980 act which requires FCIC to

implement, evaluate, and report on an individual risk underwriting pilot program that would be based primarily on farmers' production histories. Although FCIC issued the required report in July 1986, the APH Program had already been implemented on a national basis for all the major crops.

Studies Support Need to Set Yields Based on Actual Production

An FCIC consultant, a USDA task force, we, and others have recommended that FCIC develop a system of establishing insured yields based on farmers' actual production histories. These studies showed that the Area Coverage Plan used by FCIC prior to APH encouraged farmers with below average production to participate in the program while discouraging participation by farmers with above average production. This resulted in what is commonly referred to as adverse selection.

Under the Area Coverage Plan, a farmer's insured yield was based on the average yield of all farmers in a county or other geographic area rather than on the farmer's own yield. With loss payments based on average yields, it would be cost beneficial for a farmer with below average yields to participate because he or she would have to have only a small reduction to have an insurable loss. The reverse would be true for a farmer with above average yields. The net result was that below average producers were more likely to participate in the program than above average producers which increased FCIC costs.

The 1980 act required that FCIC conduct an individual risk underwriting pilot program which, among other things, would

provide yield guarantees determined from the farmers' actual yield history in at least 25 counties. The pilot project was to begin in 1981 and end after the 1985 crop year. Further, the act required FCIC to evaluate the pilot program and submit a report on the program's operation to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry. The report was to include FCIC's recommendations with respect to implementing the program on a national basis. In September 1985 the House Committee on Agriculture, in its report on the Food Security Act of 1985 (H. Rept. 99-271), referred to this requirement and stated that APH was an outgrowth of the 1980 act and therefore the Committee expected FCIC's report prior to expansion of the APH Program.

FCIC subsequently prepared a report which it sent to the legislative committees in July 1986 after the APH Program was already implemented on a national basis for all the major crops.

In explaining why APH was not evaluated and reported on before implementing it on a national basis, the former Manager told us that APH was still considered developmental in that many farmers did not have the records needed to implement the program as designed.

FCIC CHANGES IN DEFINITION OF A FARM UNIT

On April 10, 1985, FCIC's Board of Directors approved a resolution that, in effect, would have prevented most farmers from subdividing farms into multiple units for crop insurance purposes. This is commonly known as the unitization rule.

The Board's April 1985 decision to move to a unitization approach, had it not been rescinded, would have prevented most farmers from subdividing farms into multiple units within a county for crop year 1986 and within a state for crop year 1987. FCIC officials and Board members told us that concern about farmers manipulating unit production records to qualify for or increase a loss claim has been a long-standing concern. Specifically, they were concerned that farmers with multiple farm units were manipulating production records among farms to obtain fraudulent insurance claim payments.

The Board and FCIC management devoted considerable effort to this issue. For example, the Board discussed unitization in 12 of the 30 meetings it held from late 1980 to April 1985. Further, FCIC management and staff devoted considerable effort in analyzing and developing proposals to change the unit rules. No studies were made, however, to determine to what extent farmer manipulation of production records was a problem. In the meantime, FCIC went ahead and implemented the new unitization rules for two crops in 1985.

On September 16, 1985--5 months after it approved the unitization rule--the Board decided to delay further implementation of the rule until actuarial studies were done and field hearings were held. The decision to delay was prompted by strong farmer and industry opposition to the change. The results of two subsequent studies and field hearings were presented to

the FCIC Board in March and April of 1986. Neither of the two studies supported FCIC's concern.

On May 8, 1986, the Board rescinded its decision but passed a resolution that FCIC begin requiring farmers subdividing farm units to pay a premium surcharge to cover the additional administrative burden of handling policies with multiple units. Present plans are to impose the surcharge in crop year 1988. Imposition of the surcharge may require legislative action because the Federal Crop Insurance Act, as amended, does not authorize FCIC to include administrative and operating expenses in fixing premium rates.

LEGAL DETERMINATIONS PROVIDED FCIC

At your request, we reviewed FCIC's action to assure itself that several major decisions it made conformed to legislative requirements. We found that FCIC routinely asks USDA's Office of General Counsel (OGC) to review and approve all reinsurance and master marketer agreements, proposed changes to regulations, and major proposals presented to the Board of Directors. Although FCIC decisions were reviewed and approved by OGC, we disagreed with FCIC's decision to transfer $50 million in appropriations for administrative and operating expenses to the FCIC Insurance Fund to pay indemnity claims and we questioned FCIC's authority to reimburse reinsured companies for the payment of state premium taxes. In addition, one point you specifically asked us to review was the legality of FCIC's use of unearned premium

subsidies to make indemnity payments. Our preliminary review disclosed no legal objections to this practice.

Because of cash flow problems I mentioned earlier in my testimony, in March 1985 FCIC requested OGC's opinion on the legality of transferring $50 million appropriated for administrative and operating expenses to the Insurance Fund. According to OGC and FCIC officials, FCIC was orally advised that the entire $50 million transfer was legal. Thus, FCIC transferred the $50 million under the authority of section 2257 of title 7 of the United States Code. However, we found that under this section appropriated funds interchanged between accounts are subject to certain limitations. We apprised FCIC in August 1985 that, in our opinion, only $14 million of the $50 million could be legally transferred because of the prescribed limitation (7 percent of the affected appropriation). Accordingly, in August 1985 FCIC restored the entire $50 million by using the proceeds from the sale of $50 million in capital stock.

In our opinion, FCIC's decision to reimburse reinsured companies for state taxes on premiums is questionable. The Federal Crop Insurance Act specifically exempts FCIC from the payment of all taxes imposed by states. The 1980 act directs FCIC to pay operating and administrative costs incurred by reinsured companies to "the same extent that such costs are covered by the Corporation on the Corporation's policies of insurance." Thus, because FCIC cannot pay state premium taxes on

its own insurance policies, we question whether it should pay such costs to reinsured companies.

Finally, I would like to briefly discuss your concern about FCIC's use of unearned premium subsidies to pay indemnity claims. We believe that this practice conforms with existing statutes.

Premium subsidies are paid from appropriations made to the Insurance Fund. For fiscal years 1982-86, appropriations to the Fund totaled about $503 million but only about $402 million was needed to pay premium subsidies. FCIC used the balance of $101 million to fund its losses, that is, the excess of indemnities over premium income.

The annual appropriations to the Fund are lump-sum appropriations for payments under section 508(b) of the Federal Crop Insurance Act, as amended. Section 508(b)(1) authorizes FCIC to fix actuarially sufficient premium rates and to establish a reasonable reserve against unforeseen losses. Section 508(b)(3) directs FCIC to subsidize a portion of farmers' premiums. In essence, the premium subsidy, as part of premium income to the Fund, is used to pay indemnities. Because the appropriations for section 508(b) activities are lump-sum appropriations that are not specifically restricted to premium subsidy payments, our preliminary conclusion is that moneys appropriated to the Fund that are not used for the premium subsidy can be used to pay indemnities.

- - - - -

That concludes my statement. We will be glad to respond to any questions.

COMPARISON OF FCIC FORECASTS VS. ACTUAL EXPERIENCE --FY 1981 THROUGH FY 1985--

	Fiscal years					
	1981	1982	1983	1984	1985	Total
	(dollars in thousands)					
PREMIUM INCOME						
Forecast	$120,000	$439,748	$ 876,700	$ 850,000	$ 620,000	$ 2,906,448
Actual	379,169	398,668	289,269	434,638	439,850	1,941,594
Difference over/(under)	259,169	(41,080)	(587,431)	(415,362)	(180,150)	(964,854)
Percentage diff. to forecast over/(under)	216	(9)	(67)	(49)	(29)	(33)
INDEMNITIES:						
Forecast	$108,000	$395,773	$ 789,030	$765,000	$ 558,000	$ 2,615,803
Actual	407,439	528,073	594,824	635,048	653,426	2,818,810
Difference over/(under)	299,439	132,300	(194,206)	(129,952)	95,426	203,007
Percentage diff. to forecast over/(under)	277	33	(25)	(17)	17	8
GROSS INCOME:						
Forecast	12,000	43,975	87,670	85,000	62,000	290,645
Actual	(28,270)	(129,405)	(305,555)	(200,410)	(213,576)	(877,216)
Difference over/(under)	(40,270)	(173,380)	(393,225)	(285,410)	(275,576)	(1,167,861)
Loss ratio	1.07	1.32	2.06	1.46	1.49	1.45

Note: The forecast amounts shown here are those contained in the President's budget for the years shown.

Comparison of Gain and Loss Sharing Percentages for 1986 and 1983-85 Agreements

Loss ratio	Distribution of gain or (loss) 1983-85 Company[b]	1983-85 FCIC	1986 (one-state company)[a] Company	1986 (one-state company)[a] FCIC
	(percent of premiums)			
0.00	11.33	88.67	15.375	84.675
0.40	11.33	48.67	12.375	47.625
0.75	11.33	13.67	9.75	15.25
0.90	6.67	3.33	7	3
0.95	5	0	5	0
1.00	4.25	(4.25)	0	0
1.10	2.75	(12.75)	(1)	(9)
1.28-1/3	0	(28.33)	(2.67)	(25.66)
1.60	(4)	(56)	(4.25)	(55.75)
2.00	(8)	(92)	(6.25)	(93.75)
3.00	(9)	(191)	(8.75)	(191.25)
5.33-1/3	(11.33)	(422)	(14.58)	(418.75)
5.65	(11.33)	(453.67)	(15.375)	(449.625)

[a]1986 agreement has new stop loss procedures for sharing of gains and losses for companies operating in more than one state. Thus, our comparison with the prior agreements was limited to companies operating in one state in 1986.

[b]For crop years 1983-85 reinsurance agreements provided that a further distribution of the gain would be made if a positive balance existed in the companies account after a 5 year period.

Source: GAO report entitled Information on the Federal Crop Insurance Corporation's 1986 Standard Reinsurance Agreement (GAO/RCED-85-155, July 26, 1985).

Description of Stop Loss Provisions Contained in 1986 Standard Reinsurance Agreement

FCIC's 1986 Standard Reinsurance Agreement contains two provisions that limit a reinsured company's loss. These are the State Stop Loss Provision and the National Stop Loss Provision. Under the State Stop Loss Provision, a company's experience is adjusted on an individual state basis. Although FCIC does not share in any gain until after a company's business is adjusted in accordance with the State Stop Loss Provision, FCIC is responsible for losses before adjustment as follows: 80 percent of the loss for each state with a loss ratio between 1.0 and 2.0 and 90 percent of any additional loss for a state with a loss ratio above 2.0. The adjusted experience from applying the State Stop Loss Provision is then used to calculate an adjusted loss ratio which, in turn, is used as a basis for sharing any gains on the reinsured company's total business. A reinsured company receives 100 percent of the adjusted gain above a loss ratio of 0.95; 40 percent of the adjusted gain for a loss ratio of 0.85 to 0.95, and 7.5 percent of any gain below a loss ratio of 0.85.

The net result of applying these provisions is that a multi-state company could actually be paid for a gain when in fact a loss occurred on the policies it wrote.

If the adjusted experience on the reinsured company's total business results in a loss, the National Stop Loss Provision is applied as follows.

Adjusted loss after applying state Stop Loss provisions	Distribution of adjusted loss	
	Company	FCIC
(% of premiums)	-----(percent)----	
If loss is: 100.0 to 105.0	50	50
If loss is: 105.0 to 156.5	25	75
If loss is: Over 156.5	0	100