

TESTIMONY

By

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For The

AMERICAN ASSOCIATION OF CROP INSURERS

To

HOUSE OF REPRESENTATIVES

AGRICULTURE SUBCOMMITTEE ON

GENERAL FARM COMMODITIES AND RISK MANAGEMENT

Washington, D.C.

July 22, 2010

Good morning Mr. Chairman and Members of the House Agriculture Subcommittee on General Farm Commodities and Risk Management. My name is Stephen Frerichs and I am a member of the Rain and Hail L.L.C. national crop insurance team. Rain and Hail is an employee owned company and one of the U.S. Department of Agriculture (USDA) Risk Management Agency's (RMA) largest Approved Insurance Providers (AIP), writing nearly two billion dollars of policies in 49 states. Furthermore, Rain and Hail has marketed and serviced federal crop insurance policies throughout the history of the public/private partnership, which was authorized by the Federal Crop Insurance Act of 1980.

Today, I am testifying as a representative of the American Association of Crop Insurers (AACI), a trade association with membership from all areas of the federal crop insurance private sector delivery industry. On behalf of the Board of Directors and members of AACI, I want to thank you for scheduling this hearing. With development of the 2011 Standard Reinsurance Agreement (SRA), as authorized by Congress and managed by RMA, now complete, AACI appreciates the opportunity to comment on both the development process as well as the final product.

Signing the SRA Does Not Imply a Consensus Agreement

As USDA commented on several occasions, all of the AIPs signed the 2011 SRA. However, we want Members of this Subcommittee and Congress generally to fully recognize companies did not have a choice. Why? Because the companies are crop insurance companies built for the purpose of delivering the program to the nation's farmers. Not signing the SRA means the companies are immediately out of the crop insurance business, eliminating all income and jobs related to crop insurance line of business and reducing the value of those assets significantly. Therefore, the idea promoted by USDA that by signing the agreement companies willingly agreed to the SRA changes is not accurate. There is absolutely no latitude in this partnership. Sign and you're in business, at least for the short term. Don't sign and you're out of business immediately.

Mr. Chairman and Members of the Subcommittee, millions and millions of dollars and years and years of time have been devoted to organizing and building crop insurance companies in order to be an effective and efficient partner with USDA in the public/private partnership. This partnership has been so successful in offering to the nation's farmers a top quality risk management program that it is the envy of the world, which other nations are seeking to copy. It is a misrepresentation of the simple facts of the partnership for anyone to suggest that the 2011 SRA, which unilaterally makes \$6 billion of cuts in the program after Congress already made over \$6 billion in cuts in the 2008 Farm Bill, is acceptable because the crop insurance companies have signed.

It will take time to document the consequences of the necessary crop insurance company adjustments and changes made necessary by the terms and conditions, both financial and regulatory, incorporated in the 2011 SRA by RMA. In the process of implementing the 2011 SRA, we want this Subcommittee and Congress generally to know the paramount goal of the crop insurance companies will be to continue service to the nation's farmers, to the maximum extent possible. It will take some time to know whether all companies who sign the agreement can withstand the dual challenges of a lower income and more regulations instituted by the 2011 SRA.

Financial Terms Take Another \$6 Billion Cut

Despite repeated pleas for caution from across the agriculture sector as well as Members of Congress, including some who serve on this Subcommittee, RMA was unyielding in its quest to cut an additional \$6 billion from the crop insurance program over the next 10 years. As a result, many farmers who depend on crop insurance to help manage the risks associated with their

farming enterprises could suffer changes in service as companies and agencies contract or consolidate as they respond naturally to a reduction in income.

The additional \$6 billion in cuts are being imposed by the Administration before the full implementation of the more than \$6 billion in cuts imposed by the 2008 Farm Bill. Furthermore, this second \$6 billion cut will be imposed during a period of time when RMA is implementing major administrative changes to the management of the program. The RMA should have completed these administrative changes and fully implemented the cuts mandated by the 2008 Farm Bill before placing additional financial and regulatory pressure on the delivery system. Instead, the Administration is abandoning caution and moving ahead with a second round of huge reductions in financial support and implementation of concepts not provided for review in the months and months of negotiations on the 2011 SRA.

Another alarming aspect of these cuts is that they are based on a remarkable string of good weather and consistently high yields over the past several years. A long term view of weather trends would indicate that we are past due for a weather disaster that would cause large losses by the crop insurers. All of the RMA examples used to justify their cuts do not include the last year of a major drought in the Corn Belt, 1988. Most of their examples show a trend of program cost going almost straight up, a trend that cannot be sustained. However, curiously, these trend lines stop at 2008, a year of record high commodity prices and before the \$6 billion of farm bill cuts have been implemented. They do not reflect the sharp downturn in prices since 2008. By cutting the funding of the private sector delivery system so severely based on the best yield and price data ever, the RMA may seriously undermine the ability of the companies to sustain one or more significant loss years.

Never before in SRA negotiations has any administration made anything that even approached this level of reductions in the financial terms of the agreement. We believe the reduction greatly exceeds the intent of Congress in granting the renegotiation authority. The “power of the purse” is and should be reserved to the Congress. In our view, the administration exceeded its legislative mandate. Therefore, we recommend the renegotiation authority be carefully reviewed by Congress as to whether it should be repealed altogether or whether it can be modified to include appropriate safeguards, especially for maintaining the integrity of the agriculture budget baseline.

Financial Impact not Uniform Across States

The distribution of the financial impact of the 2011 SRA is by no means uniform. States in the so-called “Group 1” will be by far the hardest hit. Group 1 states include Iowa, Illinois, Indiana, Minnesota and Nebraska. Appendix Tables 1 and 2 illustrate the enormous disparity of the cuts under this agreement. As you can see from Appendix Table 1, over 80 percent of the expected 2011 cut is taken by the 5 States in State Group 1. These states represented only 34 percent of the

program premium in 2009. Both the Underwriting Gain and A&O Cap fall heaviest on these 5 States. State Group 3 actually ends up a net “winner” as the Quota Share incentive payment is expected to overcome the A&O Cap impact in these 17 States.

Additionally, the combined impact of the A&O Cap and the commission cap will be felt hardest in State Group 1. Appendix Table 2 details the impact of the A&O Cap on expected A&O payment rates. The A&O cap kicks in when A&O payments on buy-up policies exceed \$1.221 billion. A&O on buy-up policies is then pro-rated so that it cannot exceed \$1.221 billion. If A&O is pro-rated, the A&O payment rate is factored down by the pro-rated amount. Further, a new 80 percent compensation cap (80 percent of A&O payment rate) now applies to agency agreements on a State average basis. If a company has an underwriting gain (net of reinsurance costs) then the company can pay up to 100 percent of the A&O payment rate. However, initial compensation levels will have to be at the 80 percent compensation cap because a company will not know if it will incur an underwriting gain until the year is over.

Our initial estimate for 2011 is that the A&O pro-ration will be 83 percent. That means the maximum agency payment rate, on average, for Actual Production History policies will be in the area of 14 to 14.9 percent under the 80 percent compensation cap and for Revenue policies, on average, it will be in the 11.8 to 12.6 percent range. For State Group 1, this compares to average compensation (commission plus profit share) in the 23 percent range (all policies combined) in 2009. Obviously, this is a significant cut by any stretch of the imagination. On the other hand, State Group 3, where average compensation in 2009 is in the 14 percent range, may see only a marginal impact if the pro-rata estimate for 2011 bears out.

Mr. Chairman, the bottom-line is that 5 States take the brunt of these cuts – Iowa, Illinois, Indiana, Minnesota and Nebraska. We submit that is unfair and a mistake that will unduly burden these five states.

Last Minute Changes with No Industry Input

The companies are alarmed about the number of new changes that were unilaterally inserted into the final draft of the SRA without prior consultation with the industry and no chance to comment. While RMA conducted a number of meetings with companies and their trade associations throughout the negotiating period of time, they appear to have been orchestrated primarily to facilitate the objective of imposing a predetermined level of cuts and certain policy changes on the program at the industry’s expense.

For example, RMA repeatedly cited its goal of improving service for producers and the Secretary of Agriculture has focused on programs to help smaller farmers, but the final draft of the SRA goes in a completely opposite direction. Many of our companies expressed concerns about putting undue limitations on agent commissions, and then the final draft abruptly changed from

an individual policy **commission** limit to a **compensation** limit per state. Instead of rejecting a bad idea, they made it more perverse. Now it is possible for some agents to be reimbursed more than others in a state, but with a state-wide cap it becomes a zero-sum game. Companies will be able to pay some agents more than the percentage limit if overall in the state they stay within the limit. Agents will be incentivized to drop their smaller clients and produce a portfolio of larger policies with which they can negotiate a larger commission. This provision could leave smaller agents to face greatly reduced commissions and smaller producers hoping that someone will be interested in servicing their policies. AACI objects to this perverse method of dealing with agents' commissions that jeopardizes service to small and medium-sized producers.

More generally, this agreement includes precedent setting requirements that have not been even contemplated in previous SRAs and, equally important, are unheard of in normal, private insurance agreements. RMA's argument that these particular provisions are necessary to protect the financial soundness of the companies is puzzling. The annual Plan of Operation (PO) requirement provides RMA considerable latitude in its company financial oversight responsibility. A company's capital adequacy provisions can be adjusted annually by RMA in the required PO submissions, which must be approved by RMA prior to the company engaging in activities for the new reinsurance year.

Stripping Companies of Fundamental Legal Rights in Order to Protect the RMA's Own Weak Legal Position

On another front, we object to the last minute insertion of Section III(a)(2)(K) in the final agreement, even in its revised form of a covenant to not sue. Obviously, this Section is an attempt to protect the FCIC from litigation that they fear because the industry earlier brought to FCIC's attention that they did not have the authority to make some of the cuts they were proposing in the SRA. Rather than provide an adequate response to the third-party legal opinion submitted to them, RMA imposed a provision to strip the companies and the agents of their legal rights. Companies and agencies should not be forced to agree to this gross overreaching and unprecedented regulation that takes away private rights.

The Current Trend of Huge Cuts Will Destroy Many Rural Enterprises, Cost Thousands of Jobs and Undermine our Stable and Abundant Food Supply

The current pattern of using the crop insurance program as a bank to fund other priorities, as demonstrated by the 2008 Farm Bill cuts of \$6 billion and the SRA cuts of an additional \$6 billion, cannot continue. Continuing to cut federal support for the crop insurance program will

mean destruction of the primary risk protection program for commercial American farmers. This outcome would be a terrible development for the nation's farmers, rural economies and the national economy, specifically including the consumer-taxpayer, since all taxpayers are consumers.

In fact, farmers from around the nation testifying at the recently completed House Agriculture Committee's 2012 Farm Bill hearings indicated they want to, at a minimum, continue the current level of crop insurance program benefits and would like to have the benefits improved for all crops around the nation. It would be ironic, indeed, if our government were to destroy a successful crop insurance program at the very moment U.S. farmers want to expand it and other nations all over the world are trying to replicate it and make it a part of their farm safety net.

Without an effective risk management program like the current federal crop insurance program, many farmers would not be able to withstand the weather-related risks of producing crops, and they would not be able to secure adequate financing, especially in the tighter credit environment of today, to properly finance the capital intensive production of crops that agriculture has become today. These farmers would not be farming. When farmers don't farm, the nation's economy not only loses farm jobs, it also loses jobs in sectors directly related to the production of crops, including a wide array of production input products and services. Moreover, subsequently lost revenue and commercial activities from production agriculture input sales and services as well as related services, together with the related lost tax revenue, adversely impact jobs in indirect sectors, including auto and home building industries.

Moreover, when farmers don't farm, it destabilizes America's stable supply of low cost food for all of the nation's consumers. Reduced supplies of agricultural commodities raise food costs, which today represent, on average, only about 9-10 percent of disposable income in the U.S. Higher food prices increase the cost of food to all consumer-taxpayers as well as for the government's food assistance programs, meaning more funding would be needed for the Supplemental Nutrition Assistance Program (SNAP) and all other related programs.

Time for Intellectually Honest Program Accounting and Analysis

RMA constantly invokes the Milliman studies it commissioned on "reasonable" and "historical" rates of return as the analytical basis for its decision to make additional cuts in crop insurance company income. From our understanding of fair and balanced research methodology, we conclude these studies are flawed because of key assumptions imposed by RMA.

The "reasonable" rate of return study produced a result that is biased to the high side because it does not accurately account for the true level of risk associated with production agriculture. This bias was introduced to the analysis through the RMA requirement that the study not include the disaster experience of 1988 and other disasters in the earlier 1980s. Milliman, to its credit,

makes note of that fact. In all economic settings, higher levels of risk demand and earn higher rates of return. We wonder if the risk factor in the study was intentionally biased downward by excluding a high loss year to show a lower rate of “reasonable” return.

The “historical” rate of return study also produced a result that is biased to the high side because it does not accurately account for the true costs associated with delivering the modern federal crop insurance program, especially given the required capital amounts, compliance rules and massive set of regulations. This bias was introduced to the analysis through the RMA requirement that the study make the assumption that total cost of delivery exactly equals the A&O payment amount, a totally arbitrary assumption, with the result of biasing cost of delivery to the low side. Several industry studies over the last 10 to 15 years have all shown total cost of delivery to exceed A&O payments by 4 to 6 percent of premium. RMA has not commissioned a study to analyze the true and total cost of delivering the modern crop insurance program. Although, RMA recently indicated it would conduct the study in the next year or so.

Collectively, these RMA assumptions have created a biased public view of the rate of return to crop insurance companies over time. If RMA is truly interested in the financial health of the companies, as it has publicly stated and given as justification for key new 2011 SRA regulations, specifically including the agent payment cap, it is time to produce an intellectually honest analysis of the profitability of delivering the program. We urge this Subcommittee to make such a study the highest priority.

Need for Stability, Clear Vision and Confidence

It has taken not only years, but decades to have the federal crop insurance program attain the current levels of participation and benefit for our nation’s farmers. Only in America could this public-private partnership have been so successful. While certainly there is opportunity to continue improving the program, today it stands second to none as a world-class agriculture risk protection and management tool.

A lot of people have contributed to the development and evolution of the modern crop insurance program, however, no effort has been greater than that made by Congress and members of this Subcommittee. On behalf of the AACI membership and the farmers we serve, I want to take this opportunity to thank you for your support of a quality risk protection and management program. Given the natural and global market elements they work and live with every day that are beyond their control, our farmers deserve the certainty and predictability of the risk management program you have provided.

But an important and critical point must be made here and that is private sector ingenuity, creativity and capital have contributed significantly to the building of the crop insurance program in operation today, especially the farmer service component. We believe private sector

participation is an irreplaceable factor in assuring maximum farmer satisfaction with the program.

However, crop insurance companies, as is the case for companies in other sectors of the nation's economy today, need an extended period of stability, both financial and regulatory, to develop greater confidence in the partnership with the government as regulator. The companies need a clearer vision of the financial future, a coherent and consistent plan for understanding and managing the massive set of new regulations and an effective plan to deal with a lower income. It is important to make these points because we are concerned that the potential for unintended consequences inherent with some of the changes included in the 2011 SRA is not recognized nor understood by the regulator.

In the authorization language, Congress limited the administration to one renegotiation of the SRA every five years. We urge Congress to abide by the same time interval and set the crop insurance program aside for five years regarding further budget cuts. As Chairman Peterson has said, with these cuts in the crop insurance program, agriculture is the first sector in government to do its part in deficit reduction. With the 2008 Farm Bill cuts and the 2011 SRA cuts, support for the crop insurance program has been reduced by over \$12 billion. These cuts to the program are deep and significant and, regardless of comments to the contrary, collectively they will have an impact on rural businesses and jobs. Therefore, we urge Congress to fully recognize these reductions and leave the crop insurance program out of any initiatives to cut federal spending for five years, including budget reconciliation bills and farm bills.

APPENDIX

APPENDIX TABLE 1

Estimated Distribution of 2011 Cut by State Groups

	Percent of Cut
State Group 1	83.8%
State Group 2	22.0%
State Group 3	-5.8%

Group 1 States: Illinois, Indiana, Iowa, Minnesota, and Nebraska.

Group 2 States: Alabama, Arizona, Arkansas, California, Colorado, Florida, Georgia, Idaho, Kansas, Kentucky, Louisiana, Michigan, Missouri, Mississippi, Montana, North Carolina, North Dakota, New Mexico, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Texas, Virginia, Washington, and Wisconsin.

Group 3 States: Alaska, Connecticut, Delaware, Hawaii, Maine, Massachusetts, Maryland, Nevada, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Utah, Vermont, West Virginia, and Wyoming.

APPENDIX TABLE 2

Impact of Compensation Cap under Varying A&O Cap Scenarios

		A&O Cap Impact at Selected Pro-Rata Levels on A&O Pay Rate					
	A&O Payment Rate	No Cap	90%	85%	80%	70%	65%
Actual Production History	21.9%	21.9%	19.7%	18.5%	17.5%	15.3%	14.2%
Revenue	18.5%	18.5%	16.7%	15.7%	14.8%	13.0%	12%
		Maximum Agency Pay Rates @ 80% Compensation Cap @ Selected Pro-Rata Levels					
Actual Production History		17.5%	15.8%	14.9%	14%	12.3%	11.4%
Revenue		14.8%	13.3%	12.6%	11.8%	10.4%	9.6%
2008 A&O Pro-rata would have been				64%			
2009 A&O Pro-rata would have been				72%			
2011 A&O Pro-rata expected				83%			
StateGroup 1 AverageCompensation 2009				23%			
StateGroup 2 AverageCompensation 2009				16%			
StateGroup 3 AverageCompensation 2009				14%			

Biography
STEPHEN FRERICHS

PROFESSIONAL EXPERIENCE

Present - **AgVantage, LLC**
Sept. 2001 **President**

- President of AgVantage, LLC an agricultural government relations and consulting firm based in Alexandria, Virginia.

Aug. 2001- **McLeod, Watkinson and Miller**
Dec. 1997 **Government Relations/ Economist**

- Manager of the American Association of Crop Insurers (AACI). A non-profit trade association with over 10,000 members.

Dec. 1997- **Office of Management and Budget, Executive Office of the President**
July 1990 *Deputy Branch Chief, Agriculture Branch/ Senior Budget Examiner*

- Advised OMB policy officials on planning, budget, legislation, and regulatory issues.

July 1990- **Economic Research Service, U.S. Department of Agriculture**
Jan. 1989 *Economist*

EDUCATION

Dec. 1987 M.S. Economics, University of Minnesota
May 1985 B.S. St. Olaf College, Minnesota

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2007.

Name: STEPHEN FREDICHS

Address: 507 CATHEDRAL DR

Telephone: _____

Organization you represent (if any): American Association of
Crop Insurers

1. Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2007, as well as the source and the amount of each grant or contract. House Rules do **NOT** require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:

Source: None Amount: _____

Source: _____ Amount: _____

2. If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2007, as well as the source and the amount of each grant or contract:

Source: None Amount: _____

Source: _____ Amount: _____

Please check here if this form is NOT applicable to you: _____

Signature: Stephen Fredichs

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.