

RISK ASSESSED MARKETING

DR. G. A. "ART" BARNABY, JR.

PHONE: 785-532-1515

FAX: 785-532-6925

WEB Page <http://www.agecon.ksu.edu/risk/>

E-MAIL: abarnaby@agecon.ksu.edu

E-mail Art to be added to Mail List

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Disclosure: Dr. Barnaby's research was the basis for the privately developed Crop Revenue Coverage.

Crop Insurance Premium Discounts for Growers¹

Introduction. Recently the Federal Crop Insurance Corporation (FCIC) Board of Directors approved the Premium Discount Plan (PDP). The approval was given to Converium Insurance North America, Inc. (CINA) and its managing general agent, Crop1. The approval was granted under section 508(e) of the Federal Crop Insurance Act. The law requires insurance providers to show a specific savings in the delivery of the crop insurance program that will not adversely affect the service to policyholders before they are allowed to discount premiums.

In the Risk Management Agency's (RMA) press release RMA states the approval of Crop1's proposal does not limit other insurance companies from submitting similar proposals. However, based on informal interviews it appears that Crop1 will be the only company offering the PDP program in 2003. The other companies will likely watch Crop1 to judge its level of success before they file for PDP, if they file.

Based on RMA's press release, PDP sales and service will primarily be conducted online via Crop1's Internet site (<http://www.crop1ins.com>). Crop1 is recruiting crop insurance agents but its business plan depends on referrals from people whose primary business is not crop insurance, such as seed dealers, implement dealers, farm creditors, etc. Based on Crop1's WEB page, one

¹Prepared by G.A. (Art) Barnaby, Jr., Professor, Department of Agricultural Economics, K-State Research and Extension, Kansas State University, Manhattan, KS 66506, January 27, 2003, Phone 785-532-1515, e-mail – abarnaby@agecon.ksu.edu

will find few crop insurance agents or ag lenders listed as affiliates. Many lenders also sell crop insurance and commissions help cover their costs. If lending-crop insurance agents accept the reduced referral rate they will have to cover their cost with returns from loans or other fees.

Once a referral has come in through the Internet or 800 number, Crop1 will sell the policy. Crop1 has licensed agents who will actually sell the policy, because many people providing referrals are not licensed insurance agents however, some of those people making referrals will apply for an insurance agent's license. Crop1's concept of direct sales for a discounted premium via the internet is new to crop insurance but similar models have been applied to property casualty insurance. Other companies have stated they have done some testing of direct crop insurance sales but without premium discounts. However, the author has no direct knowledge of those programs.

One concern by growers might be what if the company fails? Crop1 is probably a new name for many growers because it is a "small" insurance company that writes coverage in only 12 states. However, Crop1 is the managing general agent that is backed financially by Converium Insurance North America, Inc. (CINA). Based on Converium's WEB page, it is a global reinsurer with very high ratings that wrote \$2.483 billion in net reinsurance premiums in 2001 and had 9.5 billion in assets.² So it is unlikely the company will fail, but even if it did, growers would still have their insurance claims paid because USDA-RMA will pay the claims if any company runs out of cash. Other lines of private insurance purchased by growers do carry the risk of payment for company failure but **not** crop insurance that is reinsured by USDA. Company failure is not a risk that growers need to worry about.

What does the Premium Discount Program (PDP) do for Growers? PDP will discount the crop insurance premiums charged to growers and that discount will range from a low of 5.65 percent to a high of 11.1 percent. The actual premium discount is 3.5 percent of the total premium but that total premium, includes both the government paid portion and the farmer paid portion of the insurance premium. Therefore, if growers were paying 100 percent of the premium cost, the premium discount would be 3.5 percent. However, growers do not pay the full premium cost because the government pays a share of the premium but growers receive the 3.5 percent discount on the government paid portion of the premium too. Because the government subsidizes different coverage levels at different percentages is the reason the percent discount on farmer paid premiums varies by coverage level. Most of the insurance contracts sold in Kansas are either revenue insurance or MPC1-APH at 70 or 75 percent coverage levels. The premium discount at 70 percent coverage is 8.54 percent and at 75 percent coverage the farmer paid premium discount is 7.78 percent.

What States have been Approved for PDP? The Premium Discount Plan (PDP) was approved as a pilot in 7 of the 12 states that Crop1 writes insurance. The PDP plan is approved for Kansas, Iowa, Illinois, Indiana, Minnesota, Nebraska, and North Dakota. Crop1 also writes insurance in Colorado, South Dakota, Missouri, Wisconsin, and Ohio. However, no premium discount is currently offered in those states. The premium discounts applies to corn, soybeans, wheat, sugar beets, and grain sorghum. The premium discounts apply to all of the reinsured products that include MPC1-APH, CRC, RA, GRP, and GRIP.

²The size of Converium Insurance is based on phone conversations with Crop1 and the number may not be exact but other industry sources acknowledge that Converium is a "large" company with an AM Best rating of A but that is down from A+. Like all insurance companies the crop insurance contracts are reinsured by USDA-RMA.

Who is providing the PDP Program? Crop1 is the only approved provider of the PDP program. While other companies could file for approval, it is unlikely that any more companies will apply this year. Other companies will also have to go through the same approval process. Initially, one would expect that other companies will not follow the Crop1 PDP plan but will take a wait-and-see attitude on how many policies shift because of the premium discount.

There are other ways for companies to compete besides discounting premiums. Discounts do not always move business either, at least initially. The best example was Revenue Assurance with the harvest price option (RA-HPO) that provided nearly the same coverage as CRC but with premium discounts of 20 to 30 percent. Even with all of the companies selling RA with the discounts, the business did not all move from CRC to RA. Therefore, it is reasonable to assume that premium discounts may move only a “small” portion of business in the first year. Sales data by company are not available to the public so it will be impossible for anyone outside of RMA or the company to determine how much business was attracted with these premium discounts.

How will the “savings” being generated be passed on to growers? Based on RMA’s WEB page they suggest savings being passed on to the growers as premium discounts will be achieved by using referrals and Internet sales. RMA also stated in its press release that the company under PDP must provide the “same level” of service to the grower. So how is this company so efficient that it can accomplish both goals?

Because this is a small company it is likely they are not the low cost leader in the industry. They have fewer crop insurance contracts to spread their overhead costs. While they do not publish a commission rate for crop insurance agents (neither do other companies) on their WEB page, the word on the street is that Crop1 is trying to recruit crop insurance agents so that they don’t have to depend totally on Internet sales. However, their commission rates for insurance agents are about 40-50% less than the going rate. It is reasonable to expect very few successful crop insurance agents will switch from their current company to the new company and take a 40% to 50% cut in their commission.

Agents making this switch would have the ability to offer the lower premium rate with the PDP but they would need to more than double sales to achieve their current income levels. It has been suggested that agents will achieve these higher sales because they will not waste resources on “cold calls”. Agents will only contact referrals who will buy crop insurance. It is fair to say many agents who have e-mailed the author questioning this theory.

However, one would expect crop insurance agents that have been providing a high level of service will not lose many customers to PDP. Most former Am Ag customers have told me they will continue with their current crop insurance agent regardless of which company they elect to write coverage for in 2003. **Therefore, most of the industry expects Crop1 sales to be generated through the Internet and referrals.**

Internet Sales. Growers will need to enter their own information over the Internet. Growers on rural phone lines may find this to be a long and tedious task that requires acreage reports and other data entry items during summer growing seasons when a grower’s time is at a premium. Most growers will agree that APH based crop insurance is a very complex program that requires accuracy, legal locations for acres, units defined correctly, and an understanding of coverage rules with limited irrigation water, prevented planting rules etc.

Simpler products like Group Risk Plan (GRP) or Group Risk Income Protection (GRIP) may be easier to adapt to Internet sales because they have no units, no irrigation practices (in most locations), no prevented planting, no farm level loss adjustment, etc. In a complex program it is easy to make errors but one would assume Crop1 is legally responsible because sales are being made by one of their insurance agents, even if the grower was referred. However, because the grower entered his/her data through the Internet, it is unclear if the errors and omission's liability is shifted from the insurance agent to the grower. Who is responsible for errors and omission will likely depend on court decisions.

Will growers give up the service provided by their agent for a reduced premium? It is reasonable to expect some growers will elect to buy discounted crop insurance on the Internet and bypass their local crop insurance agent. The most likely Internet customers are the very "large" farms. A discount for a large farm generates a lot more dollars than a discount for a small farm. Many large farms are set up where management does very little of the "tractor driving." They are full time managers in the office making market decisions, farm program decisions, purchasing inputs, and have computers and Internet access to take advantage of the PDP program.

The surprising initial response from some large growers was they would not switch insurance providers because they like their current loss adjuster. In their view an incorrect loss adjustment could cost a larger grower a lot more dollars than what was saved with the PDP program (the author is not suggesting that Crop1 will not do a good job loss adjusting). This comment was a surprise, because most observers would have expected the customer "loyalty" would be with the crop insurance agent. RMA officials also point out that Crop1 loss adjusters will be required to meet the same educational, training, and professional requirements that are required for loss adjusters working for the other companies.

How will Crop1 make a Profit with PDP? As it turns out, this approach, if successful, could be profitable for insurance companies. Crop1 receives the same expense reimbursement as the other companies. Currently, companies receive a 24.5 percent expense payment for MPCI-APH and 21.1 percent for revenue insurance. Because a large part of the insurance sales are now revenue insurance, the average expense payment rate is probably about 22 percent. The industry "rule of thumb" is that it takes about a 10 percent expense rate to cover the operating cost of the insurance company. That leaves 12 percent to cover the cost of the PDP discount and agent/referral fees.

The traditional company is probably paying an average crop insurance agent commission of about 16% - 18% (there are stories on the street about agents being paid up to 30%, but that is likely for transferring business from another company and that would not represent the average). Also commissions are higher for agents with large insurance books than small. Commissions also tend to be higher in states that generate underwriting gains. Regardless of the level of commissions paid insurance companies only receive an average 22 percent expense reimbursement from RMA, leaving only 4 percent to operate their insurance company. If it takes a 10 percent expense rate to run the company, where does the other 6 percent come from? The company has to generate an underwriting gain in order to cover costs!

Under the PDP program Crop1 is required to use 3.5 points of the 22 percent expense reimbursement to fund the PDP. That leaves them about 18.5 percent to cover company costs and pay agent/referral fees. The word on the street is that Crop1 is offering agents with large books of business a 10-12 percent commission and 2 points to roll, or about a third to half of the current going rate. If they can get agents to write for a 10 percent commission, that will leave 8.5 percent to cover the company's costs, meaning Crop1 will only need to cover 1.5 percent of their cost rather than 6 percent with underwriting gains.

With the exception of North Dakota, the selected States all have generated good underwriting gains. In fact, over the past 14 years, Iowa and Illinois growers have paid more in crop insurance premiums than they have collected in indemnity payments. Not only do these states have underwriting gains, but in these states growers have not collected any of the premium subsidies over this period of time, at least on average.

Are Large Farms More Likely to Buy? Because most sales are likely to be Internet sales, then large growers probably are more likely to purchase from Crop1. The insurance company costs are about the same for a large farm as a small farm, but the large farm generates a larger total premium and resulting expense reimbursement from RMA. However, insurance company costs per dollar of premium declines as the size of the farm increases. If Crop1 is successful in attracting mostly large growers they may end up as the low cost crop insurance provider.

The key question is how many growers will change to the PDP plan? It is not a costless activity to change insurance providers and crop insurance agents. Many growers, at least initially, will probably question if they will get the same level of service if they switch to the PDP plan. Therefore, it is very important from Crop1's perspective that the service provided be exceptionally good on new transfers, otherwise that will be a hindrance to the expansion of their program. In addition, there is a cost to growers in time to make the switch from one insurance provider to another. Therefore, in order for PDP to be successful, Crop1 will need to make that transition period as painless as possible.

Remember, these premium discounts are based on the 2003 premiums. Depending on where one is located, premiums for some products will be higher in 2003 than they were in 2002. Therefore, the 2003 premium that is paid by growers could actually be higher in 2003 even with the PDP than premiums were in 2002. However, the premium discount would still be less expensive as advertised than premiums quoted for similar coverage by other companies on 2003 contracts.

Will other companies follow? That most likely will depend on how successful Crop1 is in attracting new business. If most of the new contracts come out of North Dakota and they move very little of the Illinois business to their company, one would expect that the other companies will not follow suit. However, if they are successful in attracting growers in Iowa and Illinois other companies may be forced to offer similar discounts. These premium discounts will clearly make less sense in states that do not generate underwriting gains.

Neither Kansas State University nor the author have any opinion on whether this is good for growers and the crop insurance industry, but the market will ultimately decide if this is a better approach for delivery of crop insurance products. One could also envision that growers may have a larger choice in delivery systems as a result of this change, similar to what has occurred in the banking industry once the market sorts out all of these competing offers.

Clearly, Crop1 would argue that they are providing the same level of service but at a reduced cost. While approval was based on delivery efficiency, some analyst may question if the efficiency is being generated through Internet sales or reduced agent commissions. Ultimately, the market will decide if the service level is the same at Crop1 versus companies that are not participating in the PDP plan.

Not the first company to offer discounts. A few years ago a group formed a COOP insurance agency in Southwest Kansas. COOP members were paid a patronage refund payment that equaled about a 3% premium discount. This COOP is still in operation. However, even with this

discount, there are a large number of successful agents that have continued to sell crop insurance without a discount.

Conclusions. Growers who are purchasing GRP or GRIP are more likely to buy crop insurance purchases over the Internet and be satisfied. The GRP contracts are based only on county level yield losses and there is no farm level loss adjustment, no units, no practices (e.g. irrigated vs. non-irrigated) (in most locations). These features would make GRP or GRIP easy to buy over the Internet. **There appears to be no logical reason for GRP and GRIP buyers to not accept the discount from Crop1.**

Internet purchase of IP, CRC, RA, and or MPCI-APH, may be a more difficult decision. Growers will be entering data for their farms via the Internet. Growers will need to keep track of RMA rules and regulations. The introduction of PDP will at the very least cause growers to ask their crop insurance agent to justify the services that are being provided versus the Internet.

The largest number of crop insurance complaints that are sent to me deal with loss adjustment. Growers who think they have been treated fairly on claims are least likely to switch companies. There is not supposed to be any difference in loss adjusting but growers have heard the “coffee shop” stories about “unfair” loss adjustment. Therefore, growers may wait to see how early Crop1 buyers’ losses are adjusted.

Critics of PDP have raised concerns about who covers losses caused by errors and omissions. Other concerns include company failure or if the reinsurer withdraws from the market. They argue that delivery savings are not being generated though improve internet technology but from lower commissions rates. Crop1 says they have these items covered so the best advice for growers is to ask questions and read the contracts carefully.

Payments. Monthly NASS prices and historical wheat and feedgrain cash prices are presented in Table 1. These prices are used to calculate the counter cyclical payments once the price weights are determined at the end of the marketing year. Price election for crop insurance is listed in table 2.

Farm Service Agency (FSA) Loans, Direct Payments and Counter Cyclical Target Prices. The payment rates and loans are listed in table 3 for 2002. These are the rates that are current in the law.

TABLE 1. NASS REPORTED MONTHLY AVERAGE PRICES FOR KANSAS AND THE UNITED STATES

	Wheat All Classes		Corn		Beans		Milo ¹	
	KS	U.S.	KS	U.S.	KS	U.S.	KS	U.S.
Jan 2000	2.31	2.50	1.81	1.90	4.41	4.62	2.79	2.86
Feb	2.39	2.54	1.95	1.98	4.59	4.79	2.96	3.08
Mar	2.36	2.59	1.97	2.03	4.88	4.91	3.09	3.21
Apr	2.28	2.57	2.02	2.03	5.10	5.00	3.11	3.24
May	2.35	2.59	2.08	2.10	5.25	5.19	3.26	3.38
June	2.59	2.50	1.89	1.91	4.96	4.92	2.79	3.32
July	2.43	2.32	1.74	1.64	4.55	4.53	2.46	2.81
Aug	2.43	2.41	1.67	1.53	4.49	4.45	2.57	2.73
Sep	2.58	2.44	1.90	1.61	4.57	4.57	2.64	2.77
Oct	2.77	2.68	1.96	1.74	4.46	4.45	2.93	3.01
Nov	2.84	2.83	2.07	1.86	4.54	4.55	3.19	3.27
Dec	2.88	2.87	2.09	1.97	4.70	4.78	3.49	3.54
Jan 2001	2.92	2.85	2.06	1.98	4.53	4.68	3.28	3.37
Feb	2.82	2.83	2.02	1.96	4.36	4.46	3.27	3.48
Mar	2.92	2.87	2.06	1.95	4.22	4.39	3.21	3.29
Apr	2.71	2.86	2.02	1.89	4.01	4.22	2.89	3.06
May	2.98	2.99	1.88	1.82	4.22	4.32	3.17	3.21
June	2.74	2.74	1.92	1.77	4.42	4.46	3.28	3.63
July	2.71	2.63	2.03	1.88	4.87	4.79	3.27	3.72
Aug	2.64	2.73	1.97	1.90	4.97	4.83	3.35	3.50
Sep	2.53	2.85	1.99	1.91	4.64	4.53	3.25	3.46
Oct	2.66	2.86	2.02	1.84	3.89	4.09	3.22	3.30
Nov	2.67	2.88	1.99	1.85	4.06	4.16	3.22	3.29
Dec	2.68	2.89	2.04	1.98	4.07	4.20	3.20	3.26
Jan 2002	2.74	2.87	2.01	1.97	4.08	4.22	3.28	3.34
Feb	2.65	2.83	1.95	1.93	4.02	4.21	3.06	3.26
Mar	2.67	2.87	1.97	1.94	4.35	4.38	3.15	3.22
Apr	2.70	2.84	1.98	1.91	4.42	4.47	3.07	3.14
May	2.61	2.81	1.97	1.93	4.69	4.64	3.14	3.17
June	2.98	2.93	2.06	1.97	4.76	4.88	3.20	3.83
July	3.27	3.21	2.22	2.13	5.39	5.35	3.57	4.06
Aug	3.71	3.63	2.43	2.38	5.60	5.53	3.93	4.21
Sept	4.33	4.21	2.49	2.47	5.44	5.39	4.25	4.30
Oct	4.56	4.37	2.52	2.34	5.20	5.19	4.36	4.35
Nov	4.19	4.25	2.54	2.27	5.42	5.46	4.31	4.32
Dec ²	3.81	3.93	2.46	2.29	5.41	5.48	4.18	4.21

¹ Milo prices are reported in dollars per CWT. ² Mid Month Value.

TABLE 2. PRODUCTION FLEXIBILITY CONTRACT PAYMENT RATE (PFC), LOANS FOR 2002 AND MPCI PRICE ELECTIONS FOR 2003 AND 2003 CROP.

2003								
	Est. ³ Pymt	Loan ¹	MPCI	CRC (RA)	Hrvst CRC Price	Hrvst RA	IP	Hrvst IP
Wheat (KC)	\$.52	2.80	\$3.15	\$3.73			\$3.53	
Corn	.28	1.98						
Milo	.35	1.98						
Barley	.24	1.88						
Oats	.02	1.35						
Soybeans	.44	5.00						
Confectionary Sunflowers (cwt)	.80	9.300						
Oil Sunflowers (cwt)	.80	9.300						
Cotton	.204	0.52				-		

2002								
	Est. ³ Pymt	Loan	MPCI	CRC/ RA ²	Hrvst CRC Price	Hrvst RA Price	IP	Hrvst IP
Wheat (KC) (bu)	\$1.06	\$2.80	\$3.15	\$3.34	\$3.09	\$3.40	\$3.04	\$2.89
Corn (bu)	.62	1.98	2.00	2.32	2.52	2.43	2.32	2.43
Milo (bu)	.56	1.98	1.98	2.20	2.39	--	2.06	2.40
Barley (bu)	.33	1.88	1.95					
Oats (bu)	.05	1.35	1.35					
Soybeans (bu)	.80	5.00	5.00	4.50	5.45	5.45		
Confectionary Sunflowers (cwt)	0.80	9.60	13.60					
Oil Sunflowers (cwt)	0.80	9.60	9.60					
Cotton (lb)	0.222	0.52	0.52	0.43	0.48			

¹Oilseeds, wheat and feedgrains have a marketing loan that does not result in a price "floor." The loan rates have not been announced for 2002.

²CRC and RA rates for spring crops are based on the February market prices.

³Estimated payment includes counter cyclical payments estimated at the maximum plus the direct payment. Many growers have already received a part of this payment in "last year's" advanced payment.

Table 3. Loan Rates, Direct Payment Rates, and Target Prices for Covered Commodities

	Loan Rates		Direct (Fixed) Payment Rates	Target Prices	
	2002-2003	2004-2007	2002-2007	2002-2003	2004-2007
Corn (bu)	\$1.98	\$1.95	\$0.28	\$2.60	\$2.63
Sorghum (bu)	\$1.98	\$1.95	\$0.35	\$2.54	\$2.57
Barley (bu)	\$1.88	\$1.85	\$0.24	\$2.21	\$2.24
Oats (bu)	\$1.35	\$1.33	\$0.02	\$1.40	\$1.44
Wheat (bu)	\$2.80	\$2.75	\$0.52	\$3.86	\$3.92
Soybeans (bu)	\$5.00	\$5.00	\$0.44	\$5.80	\$5.80
Minor oilseeds (cwt)	\$9.60	\$9.30	\$0.80	\$9.80	\$10.10
Rice (cwt)	\$6.50	\$6.50	\$2.35	\$10.50	\$10.50
Upland cotton (lb)	\$0.52	\$0.52	\$0.0667	\$0.724	\$0.724
Peanuts (ton)	\$355.00	\$355.00	\$36.00	\$495.00	\$495.00
Extra-long staple cotton (lb)	\$0.80	\$0.80	—	—	—
Graded wool (lb)	\$1.00	\$1.00	—	—	—
Non-graded wool (lb)	\$0.40	\$0.40	—	—	—
Mohair (lb)	\$4.20	\$4.20	—	—	—
Honey (lb)	\$0.60	\$0.60	—	—	—
Small chickpeas (cwt)	\$7.56	\$7.43	—	—	—
Lentils (cwt)	\$11.94	\$11.72	—	—	—
Dry Peas (cwt)	\$6.33	\$6.22	—	—	—