Statutory Issue Paper No. 108

Multiple Peril Crop Insurance

STATUS
Finalized September 12, 2000

Original SSAP and Current Authoritative Guidance: SSAP No. 78

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Farming has always been an inherently risky enterprise because farmers operate at the mercy of nature and frequently are subjected to weather-related perils such as droughts, floods, hurricanes, and other natural disasters. Since the 1930s, many farmers have been able to transfer part of the risk of loss in production to the federal government through the subsidized Multiple Peril Crop Insurance (MPCI) program administered by the Federal Crop Insurance Corporation (FCIC), an agency of the United States Department of Agriculture. Major legislation enacted in 1980 and 1994 restructured the MPCI program. The 1980 legislation enlisted, for the first time, private insurance companies to sell, service, and share the risk of MPCI insurance policies. Subsequently, in 1994, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act revised the program to offer farmers two primary levels of insurance coverage, catastrophic and buy-up.

2. Catastrophic insurance is designed to provide farmers with protection against extreme crop losses for a small processing fee. Buy-up insurance provides protection against more typical and smaller crop losses in exchange for a policyholder-paid premium. The government subsidizes the total premium for catastrophic insurance and a portion of the premium for buy-up insurance. Farmers who purchase buy-up crop insurance must choose both the coverage level (the proportion of the crop to be insured) and the unit price (such as, per bushel) at which any loss is calculated. With respect to the coverage level of production, farmers can choose to insure as much as 85 percent of normal production or as little as 50 percent of normal production at different price levels. With respect to the unit price, farmers choose whether to value their insured production at FCICs full estimated market price or at a percentage of the full price.

3. In recent years, FCIC has introduced a new risk management tool called revenue insurance. Unlike traditional crop insurance, which insures against losses in the level of crop production, revenue insurance plans insure against losses in revenue. The plans protect the farmer from the effects of declines in crop prices or declines in crop yields, or both. Like traditional buy-up insurance, the government subsidizes a portion of the premiums. One of the plans, called Crop Revenue Coverage, is available in many states for major crops. Two other plans, called Income Protection and Revenue Assurance, are available to farmers in only limited areas.

4. Companies participate in the MPCI program with FCIC through the Standard Reinsurance Agreement (SRA) per the terms of which the insurance companies share in the underwriting results of each policy. In 1999, MPCI gross written premium was $2.3 billion and total insurance in force amounted to over $30.9 billion. The program has unique loss exposure characteristics, which resulted in a gross loss ratio over 200% for 1988 and 1993.

5. The SRA reinsurance terms provide a company the flexibility to limit its exposure on a state by state basis. MPCI premium is not expense loaded, therefore FCIC pays the insurance companies, on behalf of the policyholder, a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims.

6. The FCIC utilizes an escrow account to distribute or collect additional funds. Premium (collected from the policyholders and the federal government subsidy) is deposited in the escrow account and is available to pay the claims arising under the program.

7. Existing statutory accounting practices do not address the distinctive characteristics of the MPCI line of business. Current practices within the industry vary. Accordingly, this issue paper establishes statutory accounting principles for direct MPCI premium written and the related business ceded to FCIC, and is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. This issue paper also establishes statutory accounting principles for the recently enacted Aquatic Crop Reinsurance Agreement (hereinafter included in the term MPCI).

8. Commercial multiple-peril crop reinsurance and crop hail insurance would not be impacted by this issue paper and would continue to follow existing statutory accounting principles.

SUMMARY CONCLUSION

Premium Recognition

9. MPCI gross premium is defined as the contractually determined amount specified by FCIC to the policyholder for the effective period of the contract based on the actuarially determined expectation of risk and policy benefits associated with the coverage provided by the terms of the insurance contract. In addition, gross premium shall also include the government premium subsidy paid on behalf of the policyholder.

10. MPCI ceded premium and losses are defined as the amount calculated by applying the proportional and non-proportional factors as stated in the SRA. An example of this application is shown in Exhibit A to this issue paper.

11. MPCI written premium shall be recorded as soon as an estimate can be made, but no later than the processing date. Upon recording written premium, a liability for the unearned premium reserve shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

12. The company shall disclose the method used to compute the unearned premium reserve in the financial statements.

Amounts Receivable or Payable

13. The company shares underwriting risk with FCIC and can earn or lose money according to the claims it must pay farmers for crop losses. The company earns underwriting profits when the net retained premiums exceed the net crop loss claims paid. The company incurs underwriting losses when the net claims paid for crop losses exceed the net retained premiums. These definitions do not consider underwriting expenses, which would be included for traditional statutory accounting underwriting gains and losses. The use of the terms underwriting gains and losses in this issue paper are unique to the MPCI program. As the premiums of the program are held by FCIC in escrow, the company shall recognize as a write-in asset a receivable from FCIC for the amount of the underwriting gain (as defined in this paragraph). Whereas, when the company is in an underwriting loss position, the company shall recognize a write-in liability to the FCIC for the amount of the underwriting loss (as defined in this paragraph), as the monies held in the escrow account are not sufficient to cover the company's claims. In accordance with the SRA, funds that remain in escrow will be distributed to the company at the conclusion of the contract period if the contract results in a gain to the company. If the company owes additional funds to the escrow (i.e., it is in a loss position), those funds are remitted on a periodic basis until the contract expires. These amounts shall be recorded net as the program meets the requirements of offsetting as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64). In accordance with *SSAP No. 21—Other Admitted Assets* (SSAP No. 21), the amount receivable under the Federal Crop Insurance program shall be reported as an admitted asset.

14. Amounts receivable from policyholders meet the definition of an admitted asset as set forth in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and should be accounted for in accordance with *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers* (SSAP No. 6). The due date shall be governed by contractual due date of the premium billing, and not the effective date of the contract.

Unpaid Losses and Loss Adjustment Expenses

15. In accordance with *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (SSAP No. 55), losses and loss adjustment expenses shall be recognized as expense when a covered or insured event occurs.

16. The covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event, it is necessary to establish a liability. The following are the types of future costs relating to the MPCI program:

a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the insurer as of the statement date;

b. Incurred But Not Reported Losses, (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the insurer as of the statement date;

c. Loss Adjustment Expenses: Costs expected to be incurred in connection with the adjustment and recording of losses defined in subparagraphs 16a. and 16b. of this issue paper.

Administrative Expense Payment

17. FCIC pays the insurance companies a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The expense payment associated with the catastrophic coverage shall be recorded as a reduction of loss expenses whereas the expense payment for the buy-up coverage shall be recorded as a reduction of other underwriting expenses. The company shall disclose the total amounts received for each type of coverage.

Escrow Account

18. The escrow account shall not be recorded on the financial statements of the insurance company. This account is considered an FCIC account and as such is not owned by the insurance company, however, the company's underwriting gain is reflected as a receivable in accordance with paragraph 13.

Effective Date

19. This issue paper is effective for SRA contracts entered into after January 1, 2001. A change resulting from the adoption of this issue paper shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Correction of Errors*.

DISCUSSION

20. The conclusions reached in this issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. The issue paper also relies on the conclusions reached in various other issue papers. Due to the unique terms and complicated provisions in the MPCI program and the SRA, there is very little specific guidance for insurers when accounting for MPCI premiums and losses.

21. The definition of gross premium is consistent with the contractual provisions of the MPCI program. The policyholder pays a portion of the buy-up coverage with the remainder subsidized by FCIC. As such it is consistent and reasonable to report both components as gross premium. The ceded premium is computed using the factors given in the SRA. The SRA is unlike traditional reinsurance agreements in that it includes both proportional and non-proportional coverage within the same agreement contingent upon underwriting

results. As such, it is essential that each company compute and report ceded premiums consistently. Exhibit A is included to provide an illustration of the computation. Written premium in this issue paper is accounted for differently than *SSAP No. 53—Property Casualty Contracts - Premiums* (SSAP No. 53). SSAP No. 53 states that written premium shall be recorded on the effective date of the contract whereas this issue paper states that written shall be recorded on the processing date. This difference is due to the fact that policyholders engage in the contracts before they know how much acreage will be covered under the contract. Once the crops have been planted, an acreage report is generated which is used to compute the premium due under the contract. Therefore, it would be unreasonable for the insurance company to record written premium on the effective date, as the premium is not yet determinable.

22. The amounts receivable or payable from FCIC are addressed in SSAP No. 21. SSAP No. 21 states that amounts receivable from Federal Crop Insurance programs shall be reported as admitted assets. The amount receivable from policyholders is addressed in SSAP No. 6. This issue paper clarifies that the due date of the receivable shall be governed by the contractual due date of the premium billing as the premiums are computed months after the contracts are effective. If the receivables were aged as of the effective date, they could be non-admitted before they billed.

23. Unpaid losses and loss adjustment expenses shall be recorded consistent with SSAP No. 55. The conclusions reached in SSAP No. 55 are consistent with the provisions of the MPCI program.

24. FCIC pays the insurance companies a percent of premium for the administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The requirement to show these payments as reductions in loss adjustment expenses and other underwriting expenses is because the MPCI premium is not expense loaded. Some companies simply pass these payments to the agents in lieu of commissions. In that case, the remittance would then also be recorded as an increase in other underwriting expenses (i.e., commission expense) and there would be no effect on net income.

Drafting Notes/Comments

25. Companies writing MPCI as their predominate line of insurance can experience distorted Insurance Regulatory Information System (IRIS) ratios based upon the accounting for this line of business. The acceptable ranges for the IRIS ratios should either be changed or the ratios should be footnoted by NAIC based upon the uniqueness on the MPCI line of insurance. The IRIS ratios most often affected are gross premiums to surplus, agent’s balances to surplus, and liabilities to liquid assets.

26. Commercial Reinsurance discussed in SSAP No. 62.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

Statutory literature does not specifically address the MPCI program.

Generally Accepted Accounting Principles

GAAP literature does not specifically address the MPCI program.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 3—Accounting Changes and Corrections or Errors*
- *SSAP No. 4—Definition of Assets and Nonadmitted Assets*
- *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*
- *SSAP No. 21—Other Admitted Assets*
- *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*

- *SSAP No. 62—Property and Casualty Reinsurance*
- *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*

Generally Accepted Accounting Principles
- No further guidance obtained from GAAP literature

State Regulations
- No further guidance obtained from state statutes or regulations

Other Sources of Information
- United States General Accounting Office Testimony Before the Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, March 17, 1999
- KPMG Peat Marwick Multi-Peril Crop Insurance Revenue Recognition Survey, December 18, 1996

EXHIBIT A - ILLUSTRATION OF CEDED PREMIUMS AND LOSSES

NOTES TO THE ILLUSTRATION

Fund	The reinsurance fund specified in the Standard Reinsurance Agreement (SRA).
Column 1	Reinsured Company proportional reinsurance retention percentage.
Column 2	Gross Written Premium equals the insured paid premium amount plus premium subsidy provided by FCIC.
Column 3	Net Retained Premium is the Reinsured Company retained premium after proportional reinsurance. Gross Written Premium (Column 2) times the Reinsured Company retention percentage (Column 1).
Column 4	Proportional Ceded Premium is the premium retained by FCIC after proportional reinsurance. Gross Written Premium (Column 2) minus the Reinsured Company Net Retained Premium (Column 3).
Column 5	Reinsured Company proportional reinsurance retention percentage (Column 1).
Column 6	Gross Losses equals total claim payments to insured.
Column 7	Net Retained Losses are the Reinsured Company retained losses after proportional reinsurance. Gross Losses (Column 6) times the Reinsured Company retention percentage (Column 5).
Column 8	Proportional Ceded Losses are the losses retained by FCIC after proportional reinsurance. Gross Losses (Column 7) minus the Reinsured Company Net Retained Losses (Column 7).
Column 9	Retained Loss Ratio is the Reinsured Company's Net Retained Losses (Column 7) divided by the Reinsured Company's Net Retained Premium (Column 3).
Column 10	Underwriting (Gain)/Loss is the Reinsured Company share of the MPCI program gain or loss after calculating the non-proportional reinsurance provided in the SRA.
Column 11	Non-Proportional Ceded Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting (Gain) (Column 10) if one exists. This is FCIC's share of the underwriting gain after proportional reinsurance, based on the non-proportional reinsurance gain sharing factors specified in the SRA.
Column 12	Non-Proportional Ceded Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting Loss (Column 10) if one exists. This is FCIC's share of the underwriting loss after proportional reinsurance, based on the non-proportional reinsurance loss sharing factors specified in the SRA.
Column 13	Final Retained Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Premium (Column 11). The Reinsured Company Net Retained Premium after proportional reinsurance is reduced by the amount of FCIC's underwriting gain share after non-proportional reinsurance.

Column 14 Final Retained Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Losses (Column 12). The Reinsured Company Net Retained Losses after proportional reinsurance are reduced by the amount of FCIC's underwriting loss share after non-proportional reinsurance.

Column 15 Final Retained Loss Ratio is equal to Final Retained Losses divided by Final Retained Premium.

(a) Calculated based on the loss ratios for each fund by state. Net Retained Premium (Col 3) is applied to the percentages of Section II. C. and D. of the Standard Reinsurance Agreement.

(b) If the fund is in a GAIN position then there would be Non-proportional ceded premium. If the fund is in a LOSS position then there would be Non-proportional ceded losses.

Since each fund and state stands alone in the calculations, there is a possibility of Non-proportional ceded premium AND ceded losses within the same reinsurance year. There is also the possibility of this within the same fund (some states with a Gain and some states with a Loss).

Exhibit A - Illustration of Ceded Premiums and Losses

Fund	(1) Retention %	(2) Gross Written Premium	(3) Net Retained Premium (Col 2 x Col 1)	(4) Proportional Ceded Premium (Col 2 - Col 3)
Assigned Risk	20%	20,000,000	4,000,000	16,000,000
Developmental	35%	10,000,000	3,500,000	6,500,000
Dev - CRC	35%	5,000,000	1,750,000	3,250,000
Dev - CAT	35%	5,000,000	1,750,000	3,250,000
Commercial	100%	100,000,000	100,000,000	0
Comm - CRC	100%	20,000,000	20,000,000	0
Comm - CAT	100%	40,000,000	40,000,000	0
Total Premium		200,000,000	171,000,000	29,000,000

Fund	(5) Retention %	(6) Gross Losses	(7) Net Retained Losses (Col 6 x Col 5)	(8) Proportional Ceded Losses (Col 6 - Col 7)	(9) Retained Loss Ratio (Col 7/Col 3)	(10) Underwriting (Gain)Loss (a)
Assigned Risk	20%	40,000,000	8,000,000	32,000,000	200.0%	184,000
Developmental	35%	16,000,000	5,600,000	10,400,000	160.0%	525,000
Dev - CRC	35%	7,000,000	2,450,000	4,550,000	140.0%	210,000
Dev - CAT	35%	4,000,000	1,400,000	2,600,000	80.0%	(157,500)
Commercial	100%	80,000,000	80,000,000	0	80.0%	(18,800,000)
Comm - CRC	100%	18,000,000	18,000,000	0	90.0%	(1,880,000)
Comm - CAT	100%	22,000,000	22,000,000	0	55.0%	(12,500,000)
Total Losses		187,000,000	137,450,000	49,550,000	80.4%	(32,418,500)

Fund	(11) Non-Proportional Ceded Premium (b) (Col 3 - Col 7 - Col 10 "Gain")	(12) Non-Proportional Ceded Losses (b) (Col 3 - Col 7 + Col 10 "Loss")	(13) Final Retained Premium (Col 3 - Col 11)	(14) Final Retained Losses (Col 7 - Col 12)	(15) Final Retained Loss Ratio (Col 14/Col 13)
Assigned Risk	0	3,816,000	4,000,000	4,184,000	104.6%
Developmental	0	1,575,000	3,500,000	4,025,000	115.0%
Dev - CRC	0	490,000	1,750,000	1,960,000	112.0%
Dev - CAT	192,500	0	1,557,500	1,400,000	89.9%
Commercial	1,200,000	0	98,800,000	80,000,000	81.0%
Comm - CRC	120,000	0	19,880,000	18,000,000	90.5%
Comm - CAT	5,500,000	0	34,500,000	22,000,000	63.8%
Total	7,012,500	5,881,000	163,987,500	131,569,000	80.2%

