Do you need Federal Crop Insurance? If so, how much?

BY WILLIAM T. McSWEENY
Penn State Extension Economist

Few industries are as risky as agricultural production. In addition to the financial, technological, and institutional risks encountered by most industries, farmers must contend with substantial production risks.

These latter risks, represented by varying commodity yields and/or quality, are introduced by changes in weather patterns, pest populations, and other natural phenomena.

While it is difficult to eliminate production risk, several management options are available for reducing their impact on the farm business. These options include enterprise diversification, irrigation, frost control technology, drought and disease resistant plant varieties, chemical and integrated pest management, and the purchase of crop insurance.

The crop insurance purchase decision is both an important and complex issue for many farmers. It is important because of the impact it may have on the level and variability of the farm's cash flow.

Also, the government's recent decision to substitute multiple peril crop insurance for federal disaster payments adds significance to the insurance program. It is complex because of the many options to consider when buying federally subsidized or private crop insurance.

Crop insurance is available in two basic forms: multiple peril, which includes fire and hail insurance made available under the Federal Crop Insurance Act; and fire and hail insurance sold by private insurance companies.

Under multiple peril insurance, if a crop yield falls below the guarantee level specified in the insurance policy, the insurance company, in exchange for a premium payment, agrees to compensate the farmer for the loss in production.

This arrangement may be attractive to growers for several basic reasons, as it:

• Represents an opportunity to substitute a known cost (premiums) for unpredictable and irregular losses;

• Stabilizes the farm's cash flow, thereby making the grower a lower risk user of borrowed money;

• Increases the attractiveness of forward contracting, hedging, or commodity options since the grower's risk of not being able to perform in accordance with the contract is lessened; and

• Provides the financial liquidity needed to make it through another year in the event of a crop loss.

The major long-term considerations in the grower's decision without whether or not to buy crop insurance are:

• The likelihood that crop damage below the insured level will occur and the amount of the resulting insurance payment;

• The premium cost associated with the purchase of insurance;

• The returns foregone by using cash and near-cash reserves for self-insurance.

• The financial ability of the business to withstand a crop loss and still meet cash production expenses, debt service, and family living expense;

• The farmer's attitudes toward risk.

The benefit of insurance is represented by the difference between insurance payments (item 1) and premium costs (item 2). However, this benefit does not necessarily have to be positive for insurance to be attractive. Farmers may wish to view the cost of insurance as the price paid for transferring risk to the insuring agency.

Generally, the insurance purchase decision involves a long-run evaluation of higher expected profit (no insurance) versus less variation in profit (with insurance). This trade-off is best evaluated by the individual farmer who understands that the farm business is subject to risks due to yield variation that affects his or her ability to bear financial risk.

What Exactly is Federal Crop Insurance?

The federal government has sponsored some form of crop insurance since 1938. However, until recently government insurance was available for only a few crops, and in a limited number of counties throughout the U.S.

The Federal Crop Insurance Act of 1980 provided the basis for the current program which encourages the expansion of government-sponsored crop insurance as a replacement from the Agricultural Stabilization and Conservation Service disaster payments for (ASCS). The new program is administered by the Secretary of Agriculture through the Federal Crop Insurance Corporation (FCIC).

How is the Insurance marketed?

Insurance can be purchased in two ways. One option is to enter into an agreement directly with the FCIC through a local independent insurance agent. Alternatively, an agreement can be made with a private insurance company who, in turn, writes a reinsurance agreement with the FCIC. The names of local private insurance agencies selling insurance can be obtained by contacting the local ASCS office.

What Causes of Yield Losses are Insurable?

Insurance coverage is available for most crops on unavoidable production losses caused by drought, excessive rain, hail, wind, hurricane, tornado, lightning, insect infestation, plant disease, flood, wildlife damage, fire, earthquake, volcano and many others.

However, not all of these causes are covered on selected specialty crops. All-risk insurance does not cover yield losses resulting from poor farming practices or theft.

How Much Yield Coverage Can Be Purchased?

The grower has the option of insuring at one of three yield levels: 1. 50 percent (coverage level 1), 2. 65 percent (level 2), or 75 percent (level 3) of insurable yield.

Insurance indemnities are paid only if yields fall below those yield guarantees.

How Can I Determine My Insurable Yield?

Traditionally, insurable yield was defined in different ways, depending on the crop, region of the U.S., and in some cases, the farmer's option.

Insurable yield has been based on average yields dentified by the FCIC according to similarities in soil type, production practices, yields, and loss experience. Over the years, however, farmers with yields consistently above their area yields have complained that crop insurance was not suited for

(Turn to Page D33)