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### **Ignoring Underwriting Increases Costs for Commodity Programs<sup>1</sup>**

If public policy is going to shift from Direct Payments to "risk management" then effectively Congress is creating a derivative of options and insurance. Except for Direct Payments, all of the proposed Farm Bill safety net plans that provide risk management are effectively insurance/options with 100% of the premium paid by government, but the underwriting rules; or lack of still apply. Lack of sound underwriting will allow farmers to adverse select on the program and cost will exceed CBO estimates.

The closer the yield or revenue is measured to the farm gate, the greater the need for effective underwriting rules. This is why many ag economists expect little moral hazard and adverse selection under ARRM because the yield is measured at the district yield level and prices are effectively national prices. Farm level management has little control over either of those values.

If yield is measured at the farm level then under some conditions it might pay to "plant with the seed box empty". RMA has discovered farmers can even create moral hazard when yields are measured at the county level. So if yields/revenues are measured at the farm level, then underwriting will be even

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more critical. Effective underwriting might even require multiple inspections to make sure sound farming practices are being followed but this would greatly increase the administrative costs. The fact that most of these programs require government to pay 100% of the “premium” cost requires decision makers to be even more creative when developing underwriting rules.

For example, under a “SURE” approach that combines all crops there is no way to enforce the underwriting diversification rule to prevent farmers changing from a diversified farm to a single enterprise farm. This assumes farmers continue to have management control over the selection of crops to plant. Before “freedom to farm”, Crop Base history determined the crop that could be planted. This underwriting principle will be further undermined because farmers pay none of the premium. If farmers were to pay a part of the premium, then the actuary would discount the premium for diversification. Assuming farmers will continue to have planting flexibility, the cost to enforce the underwriting diversification rule will likely exceed the benefit, so the most efficient public policies will likely be by crop.

Clearly, underwriting and rating apply and if the public policy ignores these principles then the cost will be far greater than CBO estimates. Farmers will individually do what is in their best financial interest under the new commodity program.

The applications of underwriting rules to the next Farm Bill will be a topic of discussion at the 4 State Crop Insurance conferences. Some of the proposed farm programs will also change the optimal level of crop insurance purchase. It will be important for crop insurance agents, farmers, and ag lenders to understand the relationship between crop insurance and commodity programs.

Changing ethanol policy will also impact farmers, agents, and ag lenders. Farmers will also need to continue managing the price risk in the grain markets. The price used to set the crop insurance guarantee is also determined by the market. These are two of the important topics that will be covered in the 4-State workshop.

Enrollment is open to all and we are encouraging farmers, agents, ag lenders, and other interested parties to attend. However, we are offering continuing education credit for one's crop insurance license in Colorado, Kansas, Nebraska, Oklahoma, South Dakota, and Wyoming. The participant will need to inform us of the state where they want credit, even if the workshop one attended is not in the selected state. Those who plan to fly will find the easiest location is Brush, Colorado. The Denver airport is on the East side and it is about an hour's drive on Interstate 76 to Brush.

We will cover commodity programs, grain markets, ethanol markets, precision agriculture and other selected issues during the 4 State Risk Management

Workshop starting in Brush, Colorado (November 1), Grand Island, Nebraska (November 2), Salina, Kansas (November 3) and Enid, Oklahoma (November 4). Enrollment is limited and late enrollment carries a higher registration fee. There are many other topics covered in the workshop that will interest a broad audience including insurance agents, farmers, ag lenders, USDA employees, county agents, and others. The link to review the full program is at:

<http://www.agmanager.info/events/Insurance/2011/Default.asp>

To register online:

<https://cariregistration.unl.edu/CourseStatus.awp?&course=11CROPKS1103>

I hope to see many of you at the 2011 Insurance Workshop; "Risk Management Issues in a Volatile Economy"!