

After Brexit – Domestic Alternatives to the CAP

# Risk management and 'insurance' schemes

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# Outline

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# Introduction

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Risk and ways of coping with it in agriculture is a long-running concern (Commission, EP, OECD, etc.)

Risk management toolkit part of the 2014-20 RDPs

House of Lords inquiry on price volatility and resilience (2016)

Welsh Government study on subsidised insurance for disaster relief (ongoing)

Focus on the risk for incomes from agricultural activities of farm operators

# Rationale for government interventions

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## Counter market failure (efficiency)

- Externalities / provision of public goods
- Information deficits / transactions costs
- Imperfect competition

## Equity reasons

## Political economy reasons

## Presence of Market Failure does not *by itself* justify intervention

- Technical fix available
- Perceived public benefits exceed perceived costs

## Beware of Government Failure

# Sources of risk

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## **Risks related to production factors:**

- Human or personal risk : Asset risk : Financial risk

## **Natural conditions:**

- e.g. adverse weather conditions, plant or animal diseases or pests

## **Market risk:**

- e.g. output prices falling after a production decision has been taken

## **Policy risks** associated with government changes in agricultural and related policies:

- Brexit is a current example of policy risk
- Scaling back Basic Payments may expose farm income more to market risk

# OECD classification of risks

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“Normal risk” or ‘*risk retention layer*’

The ‘*market insurance layer*’

“Catastrophic risk” or the ‘*market failure layer*’

# Tools for income risk management in agriculture

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## **On-farm strategies: (= *risk retention layer*)**

- Diversification (including off-farm gainful activities)
- Vertical integration / forward contracts
- Stabilisation/savings accounts (self-insurance)

## **Risk sharing strategies (= *market insurance layer*)**

- Private insurance – based on individual farm data (Yield; Whole-farm; Revenue) or indices (direct or indirect)
- Mutual funds for specific sectors
- Calamity funds (private and public contributions)

## **Aid provided by the government (= *market failure layer*)**

- Subsidies to private insurance premiums (to make affordable)
- Ex-post disaster aid (where risks cannot be covered by private insurance)
- Ex-ante safety nets – revenue or income

# Private Insurance suited to:

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Large number of similar exposure units

Definite loss

Accidental loss

Large [significant] loss

Affordable premium

Calculable loss

Limited risk of catastrophically large losses

# Diversity between EU countries

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JRC (2009) and FLINT (2016) point to a huge variety between EU member states in:

- National legislative frameworks for insurance
- Level of development of the agricultural insurance market (single and combined risk)
- Market penetration
- Mix between private (non-subsidised / subsidised) and publicly provided (subsidised / non-subsidised)
- Whether public support comes from EU funds or State Aid

Total premiums in 2009 (EU-26) was €1.5 billion (of which 32% was subsidy)

UK premiums were €11 million, none of which was subsidised

# EU examples

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**Spain** – history has led to a situation in which insurance is a hybrid between government and providers, covering some risks that elsewhere would be uninsurable. All providers have to charge all farmers the same price for the service (no price competition)

**Netherlands** – insurance largely provided by mutuals rather than commercial companies, often based on particular farming types (tends to counter moral hazard)

**France** – Membership of FMSE (Fonds national agricole de Mutualisation Sanitaire et Environnementale) is compulsory and in part funded through payments from the farmers social security

**UK** – insurance largely restricted to asset and personal loss (though hail damage cover available) and from a few commercial providers (such as NFU Mutual)

# The present CAP risk management toolkit

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Optional within Rural Development Policy for the period 2014 to 2020 (Article 36 of Regulation (EU) No 1305/2013), with formal report mandated by 2018:

- Financial contributions to **premiums for crop, animal and plant insurance** against economic losses to farmers caused by adverse climatic events, animal or plant diseases, pest infestation, or an environmental incident
- Financial contributions to **mutual funds** to pay financial compensations to farmers, for economic losses caused as above (operational support but not for contributions to capital funds)
- An **income stabilisation tool**, in the form of financial contributions to mutual funds, providing compensation to farmers for a severe drop in their income

Note: **re-insurance** of insurers or mutual funds is not eligible under the EAFRD (Pillar 2 support)

**Table 11.** Number of agricultural holdings and % of farms supported by EU risk management instruments under Pillar 2 (2014-2020).

	Estimated number of participating holdings			TOTAL	% of farms covered
	Insurance premium	Mutual funds	Income stabilisation tool		
Belgium - <i>Flanders</i>	1300	0	0	<b>1300</b>	<b>5</b>
Spain - <i>Castilla y León</i>	0	0	950	<b>950</b>	<b>0.97</b>
France	97000	398000	0	<b>495000</b>	<b>95.91</b>
Croatia	8300	0	0	<b>8300</b>	<b>3.54</b>
Italy	80000	5000	5000	<b>90000</b>	<b>5.55</b>
Latvia	4000	0	0	<b>4000</b>	<b>4.92</b>
Lithuania	1450	0	0	<b>1450</b>	<b>0.75</b>
Hungary	10500	0	4500	<b>15000</b>	<b>3.10</b>
Malta	1500	0	0	<b>1500</b>	<b>11.97</b>
Netherlands	1300	0	0	<b>1300</b>	<b>1.8</b>
Portugal					
- Mainland	785	0	0	<b>785</b>	<b>0.28</b>
- Azores	150	0	0	<b>150</b>	<b>1.11</b>
- Madeira	350	0	0	<b>350</b>	<b>2.57</b>
Romania	0	15000	0	<b>15000</b>	<b>0.39</b>
<b>Total</b>	206635	418000	10450	<b>635085</b>	

# Support under State Aid rules (EP 2016)

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13 MS provided subsidies to insurance premiums in 2014 (Spain and Italy by far the largest, at €220 million and €124 million, out of €454 million total), UK was zero

10 MS spent on compensation for adverse weather events, totalling €63 million (of which the UK spent €0.2 million)

8 MS spent on other natural disasters of which Germany €80 million and France €46 million accounted for three-quarters of the total €160 million, UK spend was zero

# Example – Canada (1)

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History since the 1930s of diverse programs to cushion income risk

Under Growing Forward 2 (2013-2018) initiative, the Business Risk Management tools comprise **government-run** schemes:

- AgriStability
- AgriInvest:
- AgriInsurance
- AgriRecovery

# Example - Canada (2)

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Present array the result of long evolution

Designed to make *ad hoc ex post* disaster aid unnecessary

Administered by government

Administrative costs relatively high (CAIS C\$1,000 per farm)

Heavily dependent on data from the taxation system

Stabilisation shifted from income to defined margins

Backed up by a further array of programs for Advance Payments, AgriCompetitiveness, AgriInnovation, AgriFoodTrade Service

# Example – USA (1)

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Use by farm operators of financial **instruments is relatively well developed (30% of maize, soya bean, wheat with future contract, and 15% hedge through options)**. Crop insurance well developed

History of government-supported schemes for crop revenue and whole-farm income stabilisation

Under the 2014 Farm Bill the main form of support moved away from direct support towards counter-cyclicals in the form of subsidised **private** insurances for commodities

A factor facilitating this was the good income levels at the time of drafting, and the desire to reduce government expenditure

A raft of USDA-run programmes deal with the impact and recovery of disasters – USDA *Risk Management Agency*

*AGR-Lite* replaced by similar Whole-Farm Revenue Protection (WFRP)

# USA – continued (2)

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Main dairy forms are Margin Protection Program for Dairy Producers (MPP-Dairy) (2014) and Livestock Gross Margin Insurance for Dairy Program (LGM-Dairy) (2008). (*Differ in basis of calculating margins etc. Tyler, 2016*)

Main crop forms are Agricultural Risk Coverage (ARC) and Price Loss Coverage (PLC) programs:

- ARC payments made when revenue from covered commodities falls below a benchmark level set as the Olympic average (of previous 5 years) – county-level or individual farm options
- PLC payments made when prices fall below reference levels

Subsidies represent some 62% of what is paid to private insurance companies; they also receive some direct subsidies to their operation

From 2016 Margin Protection for Federal Crop Insurance – some states (not necessarily all counties) for wheat, maize, soya bean, rice

# Income risk in UK

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Need to distinguish between problems associated with the LEVEL of income from those to do with income stability

No evidence that price volatility of commodity markets is greater now (HoL)

A degree of price instability necessary feature of functioning markets

Threat to farm businesses comes from sustained periods of unanticipated low incomes – tests the resilience of businesses

Use of risk management tools can mitigate the impacts (though not completely eliminate them)

What are the PUBLIC benefits of preventing the impacts of income risk – what happens to GDP, land use, etc. – that have to be set against the costs of intervention?

# What role for UK government intervention in risk alleviation post 2020 (post Brexit)?

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Disaster aids / recovery assistance

Provision of Knowledge Transfer, Education and Advice

Income smoothing measures (tax averaging – income reserves)

Income stabilisation tool (counter-cyclical payments)

Subsidised insurance premiums / government supported scheme

Any intervention must be aware of issues of ‘moral hazard’ and ‘adverse selection’ (though it may be the most at-risk farmers that need to be attracted – ‘adverse’ might be ‘good’)

Government intervention remains a devolved responsibility (possible co-operation?)

# Disaster aid (1)

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Clearest case for intervention to counter market failure, as private insurance is generally not available (systemic impact, lack of data on frequency, etc.).

WTO rules on declaration of disaster, 30% production loss, and on level of compensation payable

Common government tools that might be employed in UK:

- *Ex post ad hoc* payments (unpredictable budgetary costs)
- *Ex ante* contributions to disaster funds (government and private-backed “mutuals”)
- *Ex ante* Subsidised insurance (being assessed in Wales) or cross-subsidisation (Flood Re applied to housing from 2016)

USA experience suggests that *ex post* aid cannot be entirely avoided

# Disaster aid (2)

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What is the nature of the underlying problem?

- Threat to national production (compensation for asset loss appropriate)
- Threat to environment (grants for restoration)
- Welfare / poverty of farm population (family support needed)

Should UK adopt the New Zealand model?

- Planned stratified responses to disasters linked to how extensive they are
- Clean-up costs, tax relief, family support payments, local assistance, Special Recovery Measures (infrastructure) but NOT insurance support. *[Insurance does not receive any special treatment, other than earthquake]*

# Knowledge transfer and risk mitigation

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Awareness of potential income instability and ways of combatting it is a necessary precursor to action

Evidence of some market failure, particularly in some sectors and age groups (what to do about hard-to-reach farmers?) and on some issues (integration in the food chain, forward contracts, dealing in futures, etc.)

Evidence that farms can become more profitable / sustainable / resilient (though there is a methodological problem of bias in self-reporting)

Better business skills can have long-term payback

# Income smoothing actions

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Income from agriculture is inherently unstable – conventional annual taxing raises issues both of equity and efficiency

Response - tax averaging and/or tax sheltered deposits (similar to NZ Income Equalisation Scheme and AUS Farm Management Deposits)

HoL recommended exploring deposits scheme

Should this apply only to the income from agriculture or farm operator total income?

Equity issues – should these facilities be offered to other groups ('creative artists' already covered, but seaside tourism?)

# Income stabilisation payments (1)

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Superficially attractive – gives support only when incomes low (assuming payment delays can be avoided) and could focus on only low income cases

Estimates of costs of applying them in the EU (using FADN farms) indicate:

- On average much lower expenditure than current support system (welcome) In simulation exercises by the Commission in 2008 the cost was €8-12bn when Pillar 1 cost €43bn and Pillar 2 cost €10bn)
- Large variations in budgetary cost from year to year (unwelcome), especially at individual country level
- Interesting distributional implications (USA safety-net lessons, but big farms can make big losses)

# Income stabilisation payments (2)

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BUT WTO rules make it very data-demanding and administratively-heavy:

- Actual income has to be compared with the average income from farming from the same farm in the previous three years (or Olympic average of the previous 5 years)
- Payments triggered when the fall is >30%, but cannot exceed 70% of the income drop
- Ambiguity over revenue or income as basis of calculation
- Technically not feasible in EU28 but probably in UK post-Brexit (tax data?)

# Subsidised income/revenue insurance (non-disaster)

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Subsidised premiums only possible if private insurers are willing to offer policies:

- Government incentives to insurers may be needed (including subsidies on reinsurance or other guarantees)
- UK insurance providers not active in policies relating to yields, revenue or prices
- USA present model regarded as too administratively complex and not suitable to UK agriculture (HoL)

Government operation of insurance (Canada model):

- Direct operation (has UK capacity or inclination?)
- Operation contracted to commercial provider

Both North American approaches would be major departures from established UK practice and therefore face problems (technical and political)

# Something novel?

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Transfer funds to start up a **mutual** that could then become self-sustaining?

In theory support can be by contribution to start up capital, fiscal allowances to annual contributions by farmers, actual government contributions to payments made to farmers etc.

French FMSE (*Fonds national agricole d Mutualisation Sanitaire et Environnementale*) a model? It covers disease risks and environmental risks (contamination etc.)

- Compulsory participation (broad pooling of risk, avoids adverse selection, keeps contributions low)
- Common section and sector-specific sections
- Expenses of compensation refunded in part (85%) by a mix of national and EU contributions

# Conclusions for post-Brexit policy

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Prime responsibility for handling income risk remains with farm operators

There is a clear role Government involvement where there is market failure. Obvious candidates for inclusion:

- Disaster aid (though mechanism not fixed)
- Knowledge Transfer / information/ advice / training

Uncertain role for Government concerning income/ revenue insurance (or a mutual)

USA and Canadian models present technical issues that make them unlikely to be feasible in short/medium term (rejected by HoL)

What about equity or political economy rationales? *Danger of transitionals being permanent*

Any proposals will need to balance (marginal) public benefits against (marginal) public costs.  
*(Stakeholders will focus on private benefits)*