Thank you, Mr. Chairman, for the opportunity to participate in today's hearings. ARPA authorized the Risk Management Agency to approve new insurance products for livestock. ARPA also set up a mechanism to provide incentives to the private sector to create innovative insurance products. The private sector responded by creating two new insurance products that can help livestock producers manage financial risk.

Producers of hogs, fed cattle, and feeder cattle in 19 states can insure against unexpected declines in the price for their product with Livestock Risk Protection (LRP) insurance. Hog producers in Iowa can insure against an unexpected decline in the average margin (over feed costs) from hog marketings over a five-month period with Livestock Gross Margin Insurance (LGM).

Public Policy Justification for Federal Livestock Insurance

LRP and LGM are the first federal safety net programs for livestock producers. What justification is there for Federal involvement in the livestock sector? LRP and LGM offer livestock producers who own their own livestock efficient risk management tools that allow them to manage their price risk independently of packers. Thus LRP and LGM support a policy objective of maintaining a livestock sector that is independent of packer control. Large, independent producers will find LRP and LGM useful, but they can also efficiently use similar risk management tools available to them from the commodity exchanges, such as the CME and the CBOT. But small- to medium-size livestock operations cannot efficiently use futures and options to manage their price risk because they do not have the required scale of production. Thus, LRP and LGM are most useful to small- to medium-size independent livestock operations and they serve to increase their financial viability.

The question then becomes, why do these products only cover price risk? Why not cover loss of animals? The answer is that the private insurance sector already provides coverage against accidental mortality, and it simply does not make sense to insure against losses that are caused by poor management, such as lack of disease control or poor feeding practices. Thus, for small- and medium-size operations, the current livestock products do meet a public purpose and they do not duplicate existing private insurance coverage.

Producer Acceptance of Livestock Insurance

The extent to which small- to medium-size livestock operations will use federally reinsured livestock insurance products remains to be seen, however. In the current reinsurance year, there is not a state in which more than 3 percent of eligible livestock is insured under either LRP or LGM. Iowa hogs, at 2.27 percent, and Kansas feeder cattle, at 1.94 percent, have the highest participation rates.

There are a number of reasons for this low participation. Federal livestock insurance is still a new concept. History has shown that it takes time for farmers, crop insurance agents, and insurance companies to become knowledgeable and comfortable with new products. For example, most crop insurance agents know little about price risk or the livestock sector. And most crop insurance companies know little about how to offset the risk that they assume when

issuing a policy. Market penetration of these new products will not be rapid unless companies invest in training programs for their staff and their agents.

Another reason for low participation is that both LRP and LGM were pulled from the market in December 2003 following discovery of BSE in the United States. Following substantial program modifications, sales of both resumed in October 2004. Sales momentum for both products has picked up in recent months.

It remains highly uncertain whether a large fraction of livestock will ever be insured under Federal livestock insurance programs. Based on marketing research that we recently conducted, a significant portion of cattle producers list risk management as a top concern. But whether that concern will translate into the purchase of insurance remains to be seen. We know that a significant portion of livestock producers have no interest in these programs because they do not own their own livestock and therefore face no price risk. And the experience with the U.S. crop insurance program shows that crop farmers are reluctant to buy high levels of insurance without significant premium subsidies. But extending premium subsidies to livestock producers to encourage participation would be counterproductive because livestock supplies are much more responsive to subsidies than are crop supplies. Large premium subsidies would likely lead to a significant expansion in supply and a resulting drop in market prices--exactly the event for which the livestock insurance products are designed.

My colleague at Iowa State has studied feeder pig production in Canada and attributes a significant proportion of the recent increase in Canadian production to an income guarantee that is based on the Olympic average of the previous five years of income. This allows producers to ride through the hog cycle without having to go through the tremendous stress of the low points. While this might be good for individual farmers, it has large production-enhancing, price-suppressing effects, and trade distorting effects.

Lessons Learned from the Pilot Programs

The first lesson learned is that any insurance product that uses market prices in its guarantee should not allow producers to observe market moves subsequent to the guarantee setting before deciding whether to purchase the insurance. For example, when BSE was found in December of 2003, the cattle market responded with limit-down moves, with more limit-down moves indicated. Producers clamored to buy LRP, which had a guarantee and premium that were based on the previous day's market. Clearly, farmers were trying to insure a burning barn. With regard to LGM, the guarantee was fixed two weeks before the sales closing date, allowing farmers to jump in if prices moved down during this period, or to hold off if prices moved higher. Both products now set their guarantees at the close of markets and allow sales at that guarantee only until markets open the next day.

Policy Recommendations

Over the next three to five years we should learn whether independent livestock producers find that Federal livestock insurance products are important to their operations. By then a large

proportion of hogs, fed cattle, feeder cattle, and the dairy herd will be covered by one or more of the products. In addition, agents and companies will have had time to learn how to sell the products and manage their own risk. If it turns out that a significant number of producers want to purchase livestock insurance, then Congress will need to revisit the $20 million limitation on annual expenditures that is included in ARPA.

In summary, ARPA was a success with regard to livestock insurance. It set up a mechanism to encourage the private sector to develop innovative products. It gave RMA authority and the financial means to offer reinsurance and support for the products. Some private insurance companies may be reluctant to offer price insurance because when low prices unexpectedly occur, all insured producers will be indemnified. However, most insurers will find that, in general, adding livestock insurance to their portfolio can actually reduce the overall riskiness because livestock prices are largely independent of crop prices and yields.