

Multiple Peril Crop Insurance: What is It? Should you Buy It?

Introduction

It seems that drought has become a common experience to many Maryland farmers. Adverse events like this reduce your crop yields and/or quality, and can have a significant impact on your profits, cash flow and net worth. Unfortunately, there are many adverse events including drought, excessive temperatures at pollination, excess moisture, flood, wind, frost, hail, disease, pest outbreaks, and fire which are largely **outside your control**.

Figure 1 depicts why crops fail in Maryland, as measured by the multiple peril crop insurance claims experience from 1981 to 1986.²

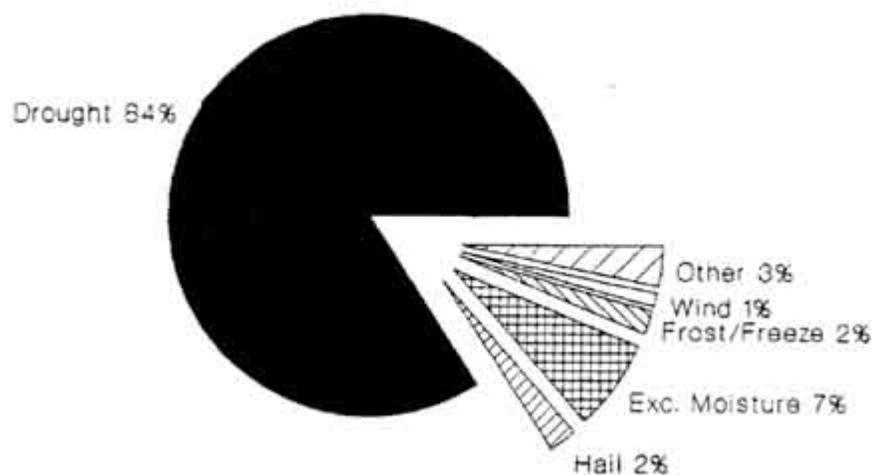


Figure 1. Why Crops Fail in Maryland

Fortunately, there are strategies that you can use to reduce the impact of these adverse events. Examples of risk-reducing strategies might include diversification or growing more than one crop; use of land tenure arrangements in which you share your risk with others, such as share rental arrangements; use of drought and disease resistant varieties and scheduling varieties to reduce risk; use of aggressive weed and pest control measures; and purchase of multiple peril and/or hail and fire crop insurance.

The purposes of this bulletin are: (1) to describe the basic features of multiple peril crop insurance

(MPCI), with emphasis on its role as a tool for reducing your financial risk; and (2) to describe a budgeting procedure that you may find useful in assessing whether you should buy crop insurance protection. Our focus will be on the impact of the purchase of MPCI on your farm's net cash flow and balance sheet should an adverse event arise. Specific details of MPCI contract provisions should be discussed with a qualified crop insurance agent.

What is Crop Insurance? Should You Buy It?

Crop insurance is available in two forms: (1) limited peril insurance, including commercial hail and fire insurance; and (2) multiple peril crop insurance (MPCI).

Hail and fire crop insurance (H/FCI) is offered under two types of plans-spot and area. Spot (acre-by-acre) plans pay you for losses based on the percentage loss occurring due to hail/fire on your damaged acres. Normal yields on non-damaged fields do not reduce payments. In contrast, under area hail and fire plans, indemnities are paid based upon the percentage of yield loss due to hail/fire averaged across your insured unit.

MPCI guarantees a minimum average yield per acre for the insured crop for the insured unit, with the minimum determined by the deductible you choose. If your average yield (adjusted for quality) for the insured unit falls below the level specified in your insurance policy, the insurance company agrees to pay you the difference. The guarantees are based on commonly accepted standards for good quality grain. Harvested yields are adjusted for quality factors such as grade, kernel quality and moisture level for insurance purposes.

Crop Insurance May Be Attractive To You Because:

1. It represents an opportunity to substitute a known cost (annual premiums) for unpredictable and irregular yield losses, particularly catastrophic losses. **You can transfer a portion of your yield risk.**
2. **It stabilizes your farm's cash flow**, thereby making you a lower risk borrower. This may improve access to and terms for borrowed money.
3. It may **provide the financial liquidity** needed to remain in farming for another year in the event of a significant crop yield loss.
4. It may increase the attractiveness **and reduce risk of cash forward contracts and hedging using \$800 futures** since your risk of not being able to perform in accordance with the contract is reduced.
5. Purchasing MPCI (if available in your county) is an eligibility requirement for emergency low-interest loans.

Major Factors Which Influence Your MPCI Purchase Decision Include:

1. Your **family's financial capacity to withstand a significant crop yield loss**; that is, your family's capacity to self-insure.
2. Your family's **willingness to take risk**; that is, your family's attitude toward the trade off between greater profit vs. lower risk.
3. The **probability of low yields**.. below your insured coverage.
4. The **expected benefits of risk reduction** from the insurance versus the annual premium cost.

The purchase of multiple peril crop insurance may simultaneously increase your long-run average net profit per year as well as reducing your downside risk. If the purchase of multiple peril crop insurance significantly reduces your probability of bankruptcy over the next decade, your long-run average net profit per year (and net worth accumulation) can increase with the purchase of MPCI.

How Has MPCCI Performed In Maryland?

Maryland farmers have used crop insurance relatively little. Of the approximate 1.8 million crop acres in 1986 only 31,000 or 1.7% crop acres were insured.

Figure 2 shows the premium that farmers have paid into crop insurance and the loss payments that they have received for 1981 to 1986. In 1986 and 1983 farmers received more in payments than they paid in premiums while during the other four years the reverse was true. The average benefit/cost ratio for the entire period was 1.45; out of every dollar in premium paid by farmers during that period they received \$1.45 in return.

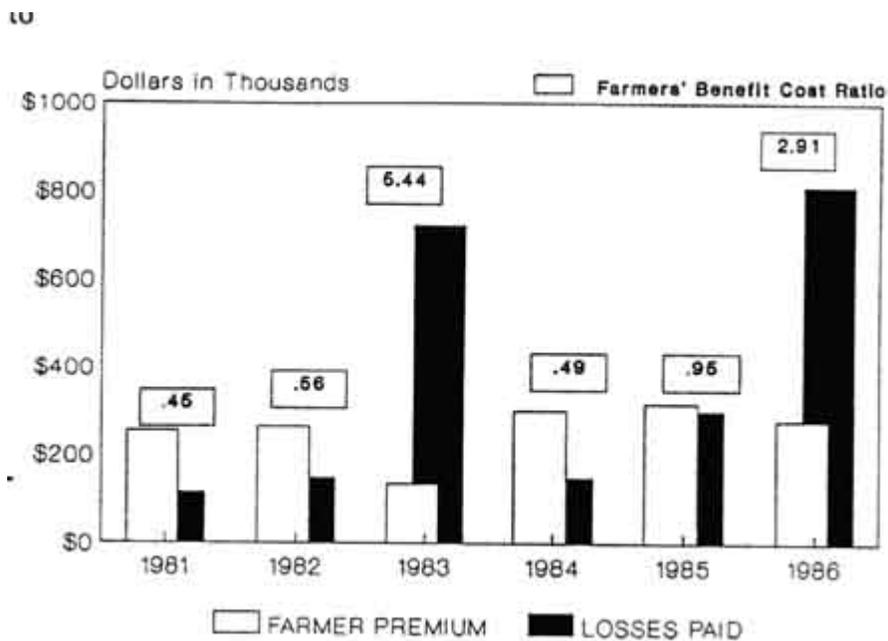


Figure 2. Farmers Premiums Paid Vs. Farmers Premiums Received

Basic Features of Multiple Peril Crop Insurance

What Crops Does It Cover?

Multiple peril crop insurance is offered on all ASCS program crops and is now available on many other commercial crops. Table 1 depicts the crops that are insurable by county.

How Is It Marketed?

Crop insurance is marketed by local crop insurance agents who, in most cases, sell crop insurance along with other lines of insurance. The objective of these agents is to provide a full range of insurance protection from crop insurance to farm/home owners' policies to meet farmers' risk management needs.

What Causes of Yield Losses are Covered?

MPCI on most crops covers unavoidable production losses caused by:

1. Drought
2. Excessive moisture
3. Hail
4. Wind
5. Frost/freeze

6. Tornado
7. Lightning
8. Flood
9. Insect infestation
10. Plant disease
11. Excessive temperature during pollination
12. Wildlife damage
13. Fire
14. Earthquake

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TABLE 1.
MULTIPLE PERIL CROP INSURANCE
Maryland

CROP INSURANCE PROGRAMS IN MARYLAND COUNTIES FOR 1988 CROP YEAR

<u>COUNTY</u>	<u>WINTER CROPS</u>	<u>SPRING CROPS</u>
Allengany	Bly, Wht	Crn, Grs, *Oat
Anna Arundel	Bly, Wht	Crn, *Oat, Soy, Tob
Baltimore	Bly, Wht	Crn, *GrS, *Oat, Soy
Calvert	Bly, Wht	Crn, GrS, *Oat, Soy, Tob
Caroline	Bly, Wht	Crn, GnP, Pot, Soy, Sue, Tom
Carroll	Bly, Wht	Crn, GrS, Oat, Soy
Cecil	Bly, Wht	Crn, GrS, *Oat, Soy
Charles	Bly, Wht	Crn, GrS, *Oat, Soy, Tob
Dorchester	Bly, Wht	Crn, GrS, GnP, Pot, Soy, Swc, Tom
Frederick	Bly, Wht	Crn, GrS, Oat, Soy
Garrett	Bly, Wht	Crn, GrS, Oat
Hartford	Bly, Wht	Crn, GrS, *Oat, Soy
Howard	Bly, Wht	Crn, GrS, *Oat, Soy
Kent	Bly, Wht	Crn, GnP, *Oat, Pot, Soy, Swc, Tom
Montgomery	Bly, Wht	Crn, *GrS, *Oat, Soy
Prince George	Bly, Wht	Crn, GrS, *Oat, Soy, Tob
Queen Annes	Bly, Wht	Crn, GrS, GnP, *Oat, Pot, Soy, Swc, Tom
St Marys	Bly, Wht	Crn, GrS, *Oat, Soy, Tob
Somerset	Bly, Wht	Crn, GrS, GnP, *Oat, Pot, Soy, SwC, Tom
Talbot	Bly, Wht	Crn, GnP, Pot, Soy, SwC, Tom
Washington	Bly, Wht	Apl, Crn, GrS, Oat, Pch, Soy
Wicomico	Bly, Wht	Crn, GnP, *Oat, Pot, Soy, SwC, Tom
Worcester	Bly, Wht	Crn, GnP, Pot, Soy, SwC, Toa

* No rate table published, consult your crop insurance agent

KEY TO CROP ABBREVIATIONS:

Apl/Apples, Ely/Barley, Cm/Corn, GnP/Green Peas, GrS/Grain Sorghum, Oat/Oats,
Pot/Potatoes, SwC/Sweet Corn, Soy/Soybeans, Tom/Tomatoes, Tob/Tobacco, Wht/Wheat

MPCI does not cover losses resulting from:

1. Poor farming practices
2. Low commodity prices (e.g., crop was not harvested because it was not worth harvesting)
3. Theft
4. Specified perils which are excluded in a limited number of policies.

How Much Coverage Can be Purchased?

There are two decisions that determine the amount of coverage: (1) the level of coverage (i.e., the amount of deductible); and, (2) the price at which yield losses are converted to cash.

Your **insurance yield** is based on your **actual production history**(APH) which is an estimate of your 10-year average yield on the insurance unit. APH provides coverage based upon your proven performance record, not county averages.

Level of Coverage. You have the option of insuring at one of three coverage levels:

1. 75% of your insurance yield (i.e., 25% deductible)
2. 65% of your insurance yield (i.e., 35% deductible)
3. 50% of your insurance yield (i.e., 50% deductible)

MPCI payments are made if yields fall below your insurance guarantee.

Your yield guarantee per acre is equal to:

Insurance yield x coverage purchased (i.e., 50%, 65%, or 75%)

For example, if your insurance yield is 110 bushels of corn per planted acre and you purchase 65% coverage (35% deductible), your yield guarantee would be:

$$110\text{bu./acre} \times 0.65 = 71.5 \text{ bu./planted acre.}$$

Commodity Indemnity Price Elections.

You must select a commodity indemnity price from the three elections available. This sets the price at which losses will be paid. For example, the 1988 low, medium, and high price elections for corn are \$1.25, \$1.50 and \$2.00, respectively.

How are Indemnity Payments Calculated?

If your average yield (adjusted for quality) is greater than your yield guarantee, no indemnity is paid. If your average yield per acre is less than your yield guarantee, the indemnity paid is equal to:

$$(Yield\ guarantee - average\ yield\ for\ insured\ unit) \times indemnity\ price.$$

For example, using our previous case example, if your yield was 50 bu./planted acre your indemnity payment would be:

$$i > (71.5 \text{ bu./acre yield guarantee} - 50 \text{ bu./acre realized yield}) \times \$2.00/\text{bu. indemnity price} = \$43.00/\text{planted acre.}$$

Indemnity payments are taxable income.

What Does Multiple Peril Crop Insurance Cost?

Premium rates are based on your historical yields and the loss history for the county in which you farm. The premium rate, as a percent of the dollar value of protection, varies with your 10 year average yield level. It's important to note that the higher your average yield levels are, the lower the premium rate is as a percent of the dollar value of protection. Contact your crop insurance agent for your premium rates.

You have the option of buying MPCCI with or without hail and fire coverage. However if you choose to opt out of the hail and fire insurance component of MPCCI, an equivalent dollar amount of hail and fire coverage must be purchased as a separate hail and fire policy.

Premiums are generally due around the normal harvest period and if not paid within 30 days of billing, interest may be charged for late payment. Premium payments are a tax deductible expense.

To encourage broader participation, Congress authorized a **30 percent subsidy for premiums** at the 50 percent and 65 percent coverage levels which is included in the quoted rates. However, if you choose 75 percent coverage, you must pay the full additional premium cost over the 65 percent level which decreases the effective subsidy rate. **You also benefit from the federal government paying all of the administrative costs** to operate the program. These two subsidies reduce your premium cost by about 50%.

Your premium/acre is calculated as follows:

$$\text{Yield guarantee} \times \text{indemnity price selected} \times \text{premium rate.}$$

For example, if we use our case example yield guarantee of 71.5 bu./acre, an indemnity price of \$2.00/bu., and an example premium rate of 2.9% the premium is:

$$71.5 \text{ bu./acre} \times 2.9 \% \text{ rate} \times \$2.00/\text{bu.} = \$4.15/\text{acre}$$

The 2.9% premium rate is based upon 65% coverage.

Do I Have To Insure All of My Crop?

If you purchase MPCCI for a particular crop, all of that crop you are raising in the same county must be insured. It is not possible to just insure the portion of a crop that is most susceptible to loss. However, each crop is insured separately, so you may insure one crop without having to insure a second crop produced in the same county. A qualified crop insurance agent can define the insurable units for the land you farm.

Claims are paid by farm unit. A single farm (located in one county) represents one unit. If you crop-share rent a second farm, the rented acreage constitutes a second unit. Providing proper records are maintained, you may qualify for more than one unit if your land is located in separate ASCS farm serial numbers.

When Must MPCCI Be Purchased?

MPCCI must be purchased by the date specified as the end of the sales period. In Maryland the closing dates generally are September 30 for winter crops and April 15 for spring crops.

Analysis of the MPCCI Purchase Decision

To determine whether to purchase MPCCI, you need to look at historical yields and project your cash flow for your farm. An example worksheet helps you project your net cash flow with and without MPCCI

coverage for alternative yields, including a typical year scenario and a low yield year scenario. It also permits examination of alternative coverage (deductible) levels.

Analyzing Historical Yields

Consideration of historical yields helps you determine the risks you face and the alternative yields you might consider in the cash flow analysis.

Let's look at a case farm example. The crop under consideration is corn, and the farmer's ASCS program acreage is 450 acres.

The farmer's corn yields per planted acre for the last ten years are as follows:

Year	Yield bu./acre
1987	50
1986	78
1985	125
1984	139
1983	73
1982	134
1981	127
1980	98
1979	125
1978	120

A good indicator of your long-run average yield can be obtained by calculating an "Olympic" average. If you have 7 to 12 years of yield data, throw out the lowest and highest yields, and calculate the average for the rest. For this farm, the lowest yield was 50 bushels per acre in 1987, a year of serious drought, and the highest yield was 139 bushels per acre in 1984. When the high and low values are thrown out, the yields remaining average 110 bushels per acre.

Historical yields help identify the range in possible yields and the average yield you might expect. Examining these yields helps you determine the risks you face and the alternative yields you might consider in the cash flow analysis.

Cash Flow Projection

The ASCS acreage for our case farm is 450 acres of corn. The farmer plans to participate in the USDA's corn program so after subtracting out 20% of his acreage for set aside he anticipates planting 360 acres of corn.

He projects his pre-harvest cash expenses at \$107.70/acre and harvest cash expenses at \$17.50/acre for normal yields and \$11.50/acre for low yields.³ The expenses for set aside acres are projected at \$5 per acre.

The farmer is considering the purchase of MPCII on his corn acreage. In addition to the cash variable expenses, money is required for the overhead expenses including taxes, debt repayment and family living. Property taxes allocated to corn acreage are \$1,500; the share of land and machinery loan payments allocated to corn acreage are \$35,625 and the share of the family living allocated to the corn is

\$7,500.

From a cash flow view on the corn crop, the requirements, are:

Cash Variable Expenses on 360 Corn Acres	
Corn production expense @ \$107.70/acre	\$6,300
Harvesting expense @ \$17.50/acre	\$38,772
Set aside @ \$5/acre	\$450
Total	\$45,522

Fixed Expenditures Allocated to Corn Crop	
Property taxes	\$1,500
Land Payment (P & I)	\$25,875
Machinery debt payment (P & I)	\$9,750
Family living (labor)	\$7,500
Total	\$49,500

TOTAL CASH REQUIRED	\$95,022
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Revenues are provided by sales and government payments. For budgeting purposes, a harvest equivalent sale price of \$1.74/bu based on the government loan rate is used. Total sales on 360 acres of corn are projected at \$68,904. Deficiency payments are estimated at \$1.23/bu., and are based on a program base yield of 110 bu./acre. That is a payment of \$135.30/acre, or \$48,708.

Estimated revenue totals \$117,612. Given cash variable expenses and overhead cash flow commitment of \$95,022, the dollars remaining for future growth, debt retirement, additional cash withdrawals and other machinery replacement net out at \$25,590-for typical yields. This analysis is for the corn crop only.

Worksheet 1 provides an organizational framework and step-by-step calculations for cash flow projections under alternative yield scenarios. The objective of the cash flow projection is to **evaluate the economic consequences of the downside risk protection provided by MPCI**, and to help you evaluate whether you have **adequate cash and credit reserves to meet a cash flow** shortfall-should it occur.

WORKSHEET 1.

ANALYSIS OF PER ACRE NET CASH FLOW

Crop: Corn
 Situation: Eastern Shore Farm

	Typical Year		Disaster Year	
	With Insurance	Without Insurance	With Insurance	Without Insurance
Projected Crop Sales & Other Cash Inflows:				
1. Enter yield/planted acre	110	110	50	50
2. Enter expected market price of crop at harvest	\$1.74	1.74	1.74	1.74
3. Expected sales: Line 1 x Line 2	\$191.40	191.40	87.00	87.00
4. Enter other receipts (deficiency pmt., straw etc)	\$135.30	135.30	135.30	135.30
5. Total receipts: Line 3 + Line 4	\$326.70	326.70	222.30	222.30
MPCI Premium				
6. Enter insurance yield	110		110	
7. Enter level of coverage (50, 65 or 75%)	65%		65%	
8. Enter premium rate for the desired coverage	\$2.99		2.99	
9. Enter crop price election	\$2.00		2.00	
10. Insurance premium: Lines 6 x 7 x 8 x 9	\$4.15		4.15	
Projected Crop Cash Requirements				
11. Enter preharvest cash operating expense	\$108.95	108.95	108.95	108.95
12. Enter harvest cash expense for yield on Line 1	\$17.50	17.50	11.50	11.50
13. Enter debt service & fixed cash requirements	\$137.50	137.50	137.50	137.50
14. Total cash requirements: Lines 11 + 12 + 13	\$263.95	263.95	257.95	257.95
Projected MPCI Payment Received				
15. Enter Line 6 x Line 7	71.5		71.5	
16. Enter Line 15 - Line 1 (enter 0 if no. is negative)	0		21.5	
17. Insurance payment received: Line 16 x Line 9	0		43.00	
NET CASH FLOW: Lines 5 - 10 - 14 + 17	\$58.10	62.75	3.20	-35.65

Sample Worksheet:

Projected Crop Sales & Other Cash Inflows:				
1. Enter yield/planted acre	_____	_____	_____	_____
2. Enter expected market price of crop at harvest	\$ _____	_____	_____	_____
3. Expected sales: Line 1 x Line 2	\$ _____	_____	_____	_____
4. Enter other receipts (deficiency pmt., straw etc)	\$ _____	_____	_____	_____
5. Total receipts: Line 3 + Line 4	\$ _____	_____	_____	_____
MPCI Premium				
6. Enter insurance yield	_____		_____	
7. Enter level of coverage (50, 65 or 75%)	_____		_____	
8. Enter premium rate for the desired coverage	_____		_____	
9. Enter crop price election	\$ _____		_____	
10. Insurance premium: Lines 6 x 7 x 8 x 9	\$ _____		_____	
Projected Crop Cash Requirements				
11. Enter preharvest cash operating expense	\$ _____	_____	_____	_____
12. Enter harvest cash expense for yield on Line 1	\$ _____	_____	_____	_____
13. Enter debt service & fixed cash requirements	\$ _____	_____	_____	_____
14. Total cash requirements: Lines 11 + 12 + 13	\$ _____	_____	_____	_____
Projected MPCI Payment Received				
15. Enter Line 6 x Line 7	_____		_____	
16. Enter Line 15 - Line 1 (enter 0 if no. is negative)	_____		_____	
17. Insurance payment received: Line 16 x Line 9	_____		_____	
NET CASH FLOW: Lines 5 - 10 - 14 + 17	\$ _____	_____	_____	_____

The example depicted in Worksheet 1 assumes 65% coverage and a \$2.00/bu. indemnity price. The 65% coverage was chosen because it provides significant downside protection, with a yield guarantee of 71.5 bu./acre. Line 11 includes the cash expenses for the cropped acres and the cash expenses for the fallow and set aside acres allocated on a per acre basis to the production acres.

The worksheet shows the net cash flow for the typical year without insurance of \$62.75/acre. In the disaster year the net cash flow is -\$35.65/acre. A sample worksheet is provided for your use.

It is useful to analyze how crop insurance would perform under historical yields. Given this farms insurance yield of 110 bu. and assuming the historical yield on page 5, indemnity payments would be received on 1 of the 10 years (360 acres x \$43/acre or \$15,480 in 1987). Assuming crop insurance is purchased each year and that the annual premium payments are typical of the \$4.15/acre for this year, \$14,940 would have been paid over the 10 years. The benefit/cost ratio would have been 1.04 in favor of the farmer. This assumes a 0 percent rate of return on the money used for insurance premium. Had this money been invested elsewhere at a reasonable rate of return, the benefit/cost ratio would not have been favorable. However a farmer should not view this as only an investment decision, but should weigh heavily the decision criteria listed on pages 1 and 2.

Comparison of Coverage Levels

Another aspect in the budgeting process is to evaluate the performance of alternative coverage levels, particularly in the shortfalls-should they occur. Which coverage level should you purchase? We begin by calculating the coverages and premiums per acre, as depicted in Figure 3. As noted earlier, the premium per acre goes up much more rapidly between 65% and 75% versus 50% and 65% coverage.

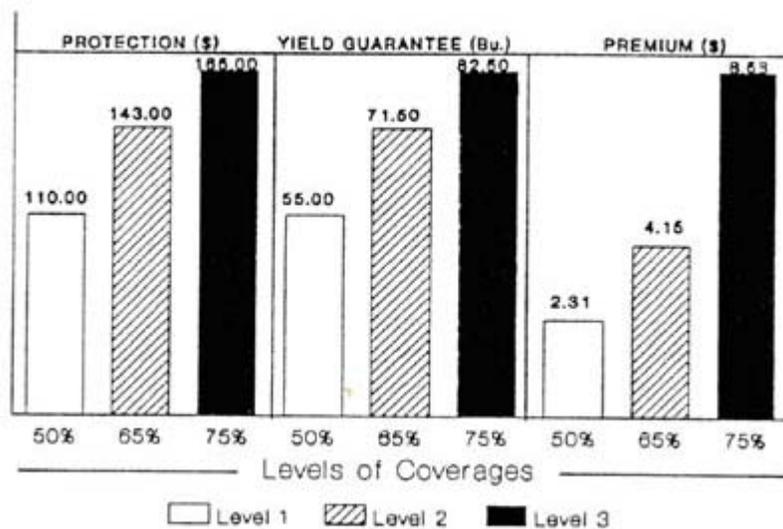


Figure 3. Protection, Guarantee, Prem./Acre Vs. Coverage Level

If we combine these impacts that the different coverage levels have on gross income graphically, (includes insurance payments and sales receipts of the yield times \$1.74 per bushel (excluding government payments which are not affected by yield variations) it looks like figure 4:

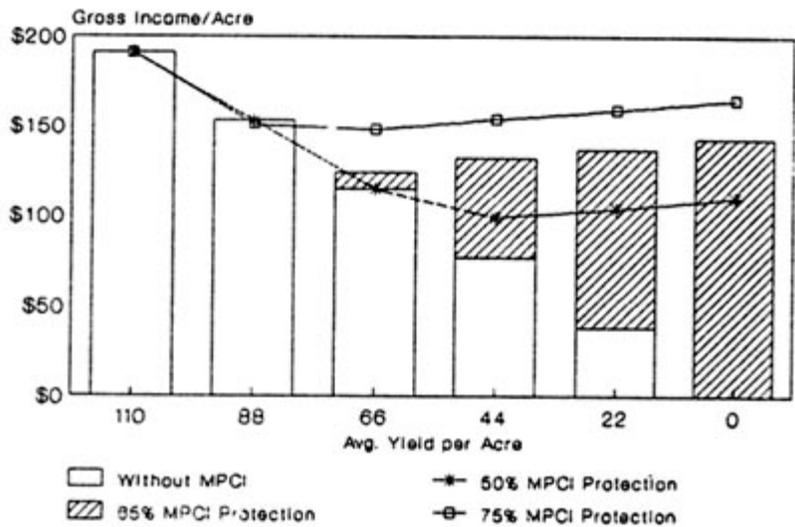


Figure 4. Gross Income With and Without MPCl

Next, the downside risk "protection" provided by MPCl is evaluated. Figure 5 depicts the impacts of the 50%, 65%, and 75% coverage levels on the net cash flow. The trade-off between annual premiums per acre and downside protection on the net cash flow is illustrated. The \$2.00 price election is used for these comparisons.

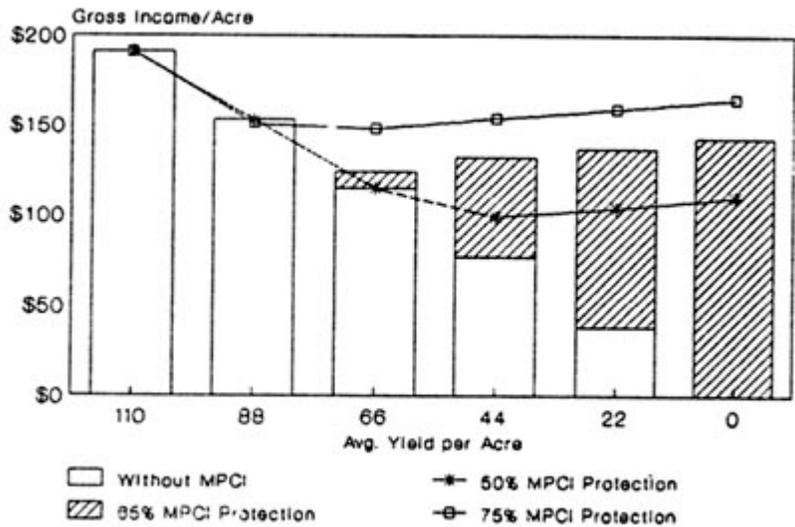


Figure 5. Net Cash Flow With and Without MPCl

The 65% coverage level puts a floor under net cash flow at a level that nearly covers cash flow requirements. Note, the difference between the two columns for the typical year is the MPCl premium payment per acre.

Net cash flows for yields above 88 bushels are similar for the 50 and 65% coverage levels. At the 75% coverage level, net cash flow is reduced for yields above 88 bushels due to higher premium rates. At low yields, the net cash flow is higher for the 65 and 75% coverage levels. For example, the net cash with insurance for a 44 bushel yield is \$5/acre with 65% level of coverage.

In previous sections we looked at historical yields and cash flow projections. In this section we looked at the protection offered by the three levels of MPCI coverage. Combining all of these allows you to select a strategy that fits your situation and your financial ability to take risks.

Analyzing Your Financial Reserves

The final step in the analysis is to **develop a risk management plan**. The plan should be based on the implications of alternative strategies for the long term financial structure of the business.

Potential risks first become apparent in a cash flow analysis as was demonstrated in Worksheet 1. The calculations showed the impact on cash flow of a low yield. In this case there was a cash flow shortfall of \$35.65/acre without crop insurance.

In reviewing risk management strategies, it is helpful to trace the impact of cash flow variations through the balance sheet. The balance sheet shows the value of assets and liabilities with the difference between the two being the net worth or owner's equity in the business. A cash flow shortfall, as demonstrated in Worksheet 1, will reduce the equity in the operation. Equity represents the wealth of the owners. It can also be viewed as financial reserves. The question that you need to answer is how much you can allow these reserves to be drawn down and still maintain solvency or how much you are willing to let them be reduced.

The implications of reduced yields are influenced by the specific debt level. For instance, for a relatively low debt situation, crop insurance may not be as important as it is for the manager in a relatively high debt situation. However, the low debt manager needs to consider long run implications and the risk strategies that will contribute to achieving the long run goals of the business.

Those managers with intermediate debt may be in a position to accept the risk but one bad year would force them into a high debt situation. They would have less management control and flexibility over their farming operation. The high debt manager definitely needs to consider crop insurance as a tool that can transfer risk and help to keep the farm in business. In some cases the lender will require crops to be insured.

Selecting Your Plan

The graphic presentations demonstrate the ability of crop insurance to help stabilize cash flow and provide liquidity in the short run to preserve the long run financial reserves.

In the final analysis the benefits of crop insurance to you depend upon your family's capacity and willingness to take risks and the probability of a loss occurring. Worksheet 1 was designed to help you with the first step in evaluating your capacity to withstand yield losses. You can then apply the results of the cash flow analysis to your specific financial situation by thinking about the implications for your balance sheet.

Credits

¹ Dale M. Johnson is a Faculty Extension Assistant, University of Maryland. This publication is adapted from publications prepared by Doug Jose, University of Nebraska, Art Barnaby, Kansas State University, Gayle S. Willet, Washington State University, J. Roy Black and Gerald Schwab, Michigan State University, and from information provided by the Federal Crop Insurance Corporation and the American Association of Crop Insurers, Washington, DC. Appreciation is extended to George Stevens, Dick Levins, and Eugene Gantz for their reviews of this publication.

²Source: The American Association of Crop Insurers, Washington, DC

³Expenditures include seed, fertilizer and lime, herbicides and insecticides, drying, fuel, machinery repairs, custom hire, trucking and interest. Additional information on production costs are contained in the Maryland FINPACK crop and livestock data banks available from your Extension agent.

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by

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