Weathering the Storm: Evaluating Captive Insurance for Iowa Cooperatives in Crisis

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ABSTRACT

Iowa agricultural cooperatives are facing a crisis in obtaining affordable and comprehensive property and casualty insurance due to the withdrawal of major carriers and significant increases in premiums and deductibles. The regulatory requirements for property and casualty insurance and its importance for securing commercial loans make this crisis particularly concerning. This paper examines captive insurance as an alternative for Iowa cooperatives, outlining the benefits and challenges of a self-insurance model. While captive insurance offers customization, potential cost savings, tax incentives, and risk management benefits, cooperatives must consider high start-up costs, limited risk pooling, and selective admission. The paper also discusses strategies for overcoming these challenges, such as purchasing reinsurance and diversifying captive membership. The issue will be further explored at an upcoming cooperative CFO conference in June 2023.

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I. A Crisis for Iowa Cooperatives

Agricultural cooperatives in Iowa are facing new and significant challenges in safeguarding their assets. Austin Mutual, one of Iowa's five major carriers of coop property and casualty (P&C) insurance, recently exited the market, leaving a $100 million premium gap that the remaining four insurers are unwilling to cover.[12] In addition, the remaining insurers have dramatically increased rates and added policy exclusions that shift risk back to policyholders.[3] CoBank, a national lender for grain and farm supply cooperatives, reports that P&C insurance premiums have risen sharply for the 2023 renewal season, between 25% and 75% year-over-year. Deductibles are also climbing, with one coop CFO citing a jump from $150,000 to $5 million. The combination of rate hikes, policy exclusions, and limited supply mean that coverage is often unavailable or unaffordable for Iowa cooperatives.

It should be noted that going without coverage is not an option. The Iowa Department of Agriculture & Land Stewardship requires cooperatives to insure stored crop, as doing so protects farmers in the event of loss. In addition, most coops utilize commercial loans to finance their business activities. P&C insurance is a precondition for these loans, as it greatly reduces the probability of borrower default. Given the severity of the insurance access problem and inability to go uninsured, the current situation has been deemed a "crisis" by cooperative managers and insurance industry professionals.

The Iowa Institute for Cooperatives (IIC), a non-profit organization established in 1951 to support member coops, has been tracking this problem and searching for solutions.[4] The IIC notes that derechos and other windstorms have caused significant property damage in recent years. The 2020 derecho was particularly devastating, destroying property, equipment, and grain storage – all covered under P&C insurance. These losses have prompted insurers to revise their loss projections upward or withdraw from the market altogether.

While the supply of coop P&C insurance has been decreasing, the demand for this insurance is greater than ever. According to the IIC, the agricultural industry has seen remarkable growth, with soybean production increasing from 414 million bushels in 2012 to 587 million bushels in 2022 and corn production rising from 1.88 billion bushels in 2012 to 2.48 billion bushels in 2022 (see, Iowa Ag News – 2012 Crop Production; Iowa Ag News – 2022 Crop Production). This production has necessitated greater storage space and facility expansions, which are increasingly costly due to inflated steel prices.[5] Both the stored crop and the expanded storage facilities require P&C insurance.

Throughout Iowa, discussions on insurance have become a recurring theme in meetings among general managers and CFOs of local grain and farm supply cooperatives. While some cooperatives can absorb the rate increases and retain risks shifted to them through high deductibles and policy exclusions, others are left with no choice but to explore other options for protecting their assets.

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[1] Coop P&C insurance is generally sold as a bundle that includes commercial property, auto, liability, stock/inventory, business interruption, and business practice coverage.

[2] According to coop CFOs, Austin mutual had some of the most competitive rates for coop P&C insurance.

[3] One example of a recently added policy exclusion is for hail damage.

[4] Although Iowa has experienced considerable consolidation over the years, it is still home to 46 grain and farm supply cooperatives, all of which are IIC members. These cooperatives vary significantly in size, location, departments, volumes handled, revenue, and total assets.

[5] Brian Bailey, CFO of Heartland Cooperative, notes that excluding electricity, the cost to put up a new steel bin increased by 248% between 2012 and 2022.

II. A Role for Captive Insurance?

Given the issues associated with traditional insurance, cooperatives are exploring captive insurance as a possible alternative. Captive insurance is a type of self-insurance where one or more companies create their own licensed insurance company to cover their risks. Under most captive structures, all owners of a captive are also policyholders who pay premiums to the captive and receive coverage for specified losses.[6] Captives benefit from their ability to offer customized policies to members and are particularly useful when traditional insurance coverage is unavailable. Iowa cooperatives are considering captive insurance for this very reason – they find themselves in a "hard market," where coverage is often unaffordable or insufficient due to high deductible levels.

In addition to expanding the set of available insurance options, captives may provide several other benefits for members. First, captives generally return excess premiums to members in the form of a dividend. This may help to reduce members' insurance costs. Second, members are incentivized to limit their losses and better manage their risks. In many cases, captive members undergo regular safety inspections and risk assessments. Results offer members the opportunity to learn best practices from one another and to improve their risk profile.[7] Third, captive insurance affords certain tax benefits. When a member purchases insurance from a captive, that premium expense reduces the member's profitability and associated tax burden.[8] Additionally, when a captive holds reserves to pay future claims, those reserves reduce the captives' tax burden. Fourth, captive reserves can be loaned back to captive members, reducing their borrowing costs.

While these benefits may seem enticing, there are several costs and challenges that Iowa cooperatives may encounter when starting or joining a captive. First, start-up costs can be high. Captive members generally need to conduct a feasibility study, hire and retain a captive manager, provide initial capital, and pay ongoing premiums. In addition, members may need to make safety improvements, enhance their risk management processes, and participate in ongoing safety inspections. Second, captive insurance premiums may prove more costly than traditional insurance premiums. This is because captives have a more limited risk pool when compared with traditional insurers. The larger an insurer's risk pool, the more accurately they can predict aggregate claim amounts and the lower their premium loadings.[9] Third, not every company can join a captive. Group captives tend to have selective admission, as current members generally seek "good risks" to add to their risk pool. Fourth, if claims to the captive are significant and exceed the captive's financial reserves, captive members would need to recapitalize. Otherwise, the captive would become insolvent.

These issues are particularly pronounced for Iowa cooperatives considering the formation of a group captive for property risks. Property risk, by its very nature, tends to be positively correlated. A single storm can generate losses for numerous captive members. When positive correlation exists, risk pooling is less effective, compounding the second issue listed above. Additionally, the possibility of simultaneous large-dollar claims necessitates that the captive hold significant financial reserves. This, in turn, increases the capital and premiums that members need to contribute. For these reasons, captive insurance is more

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[6] The exception is a "rented captive," in which policyholders pay a fee to utilize a captive that is owned and operated by an outside organization.

[7] Jake Williams, CFO of River Valley Cooperative, notes that enhancing the safety culture is among the greatest benefits of captive insurance for his organization.

[8] At present, Iowa cooperatives receive favorable tax treatment under the Tax Cut & Jobs Act and may not benefit from the additional tax advantages afforded by a captive (see Provision 11011 Section 199A). However, this aspect of the Tax Cut & Jobs Act is due to sunset at the end of 2025, making captive tax advantages more relevant at that time.

[9] Premium loadings are the portion of the insurance premium above the expected loss amount. They include expenses, risk charges, and insurer profit.

frequency used for workers' compensation, general liability, auto, and health risks when compared with property risks.

Fortunately, there ways to address these potential pitfalls. The captive can purchase reinsurance, which limits its loss exposure at a specified maximum. Additionally, the captive can be structured to include members from various industries and/or from various regions of the country. Having a large and diverse membership improves risk pooling and reduces the chance that a single peril generates losses for multiple captive members. There is no maximum membership for a captive and some consist of thousands of members (Faulkner, 2018).

Generally, Iowa cooperatives will need to weigh the pros and cons of captive insurance to determine whether it is advantageous to traditional coverage. Jake Williams, CFO of River Valley Cooperative, recommends that cooperatives analyze how their organization would have performed had they participated in a captive over the past five years. Jake explained that River Valley conducted such an analysis and found that the return of premium would have likely been substantial. Additionally, Jake recommends that cooperatives consider whether their organization is ready for the "safety culture" that a captive will require, or if improvements still need to be made.

III. Conclusion

Can captive insurance help to service a P&C insurance market plagued by limited and expensive coverage? That question is increasingly being asked by Iowa cooperatives. This paper aims to shed light on some of the advantages and disadvantages of captive insurance as it pertains to Iowa cooperatives. The topic will be a central focus of an upcoming cooperative CFO conference in June 2023.

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