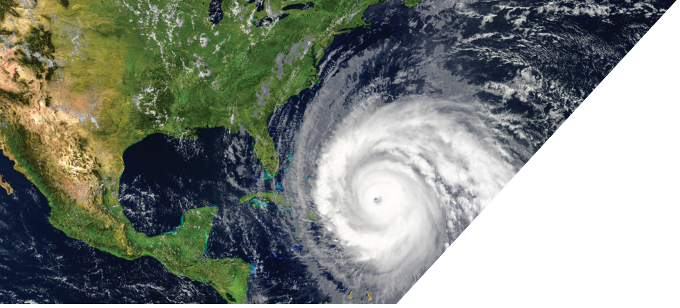

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It Is Time for Ag Co-ops to Pay the Insurance Piper

Kenneth Scott Zuckerberg
Lead Economist,
Farm Supply and Biofuels

Inside…

Key Points:

- The increasing frequency and severity of global catastrophic events over the past decade have inflicted major financial losses on society, the insurance industry and agribusiness. U.S. losses to catastrophes totaled $170 billion in 2022, which is about triple the long-term average dating to 1980.
- U.S. property and casualty (P&C) insurers have responded by raising prices. In fact, the magnitude of the three years of above-average losses has driven one underwriter, Austin Mutual, to exit the market.
- U.S. grain and farm supply cooperatives paid 40% to 60% more (risk-adjusted) during the 2023 renewal season (both January and April). Rates for customers that experienced property losses during 2020 to 2022 increased up to 100%.
- CoBank believes that commercial property insurance rates will remain elevated for the next 12 to 18 months as P&C companies attempt to make up for recent year losses and pursue rate adequacy in an environment of high costs for labor, building materials and financing.
- While there is no one "silver bullet" solution that is applicable across the board, we conclude that cooperatives can reduce some of the bite of higher P&C costs by improving internal loss control and purchasing property insurance through a hybrid insurance program.

Introduction

The world has seen an increase in the frequency and severity of adverse weather-related losses or catastrophic events that have resulted in losses to personal and business property and supply chains, not to mention loss of human life. This trend has continued into 2023, with severe floods recently impacting agricultural production in Texas as well as Europe. In the United States, the 2023 tornado season activity has already been above average with 609 confirmed tornadoes as of May 18, 2023. According to research from the National Centers for Environmental Information (NCEI) tornado activity during the first five months of the current year has exceeded the average of the past 30 years.[1]

While farmers and agribusinesses use several types of property and casualty (P&C) insurance programs to manage risk, this report focuses on commercial property insurance purchased by grain and farm supply (GFS) cooperatives to

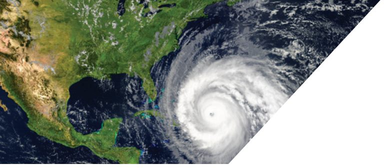
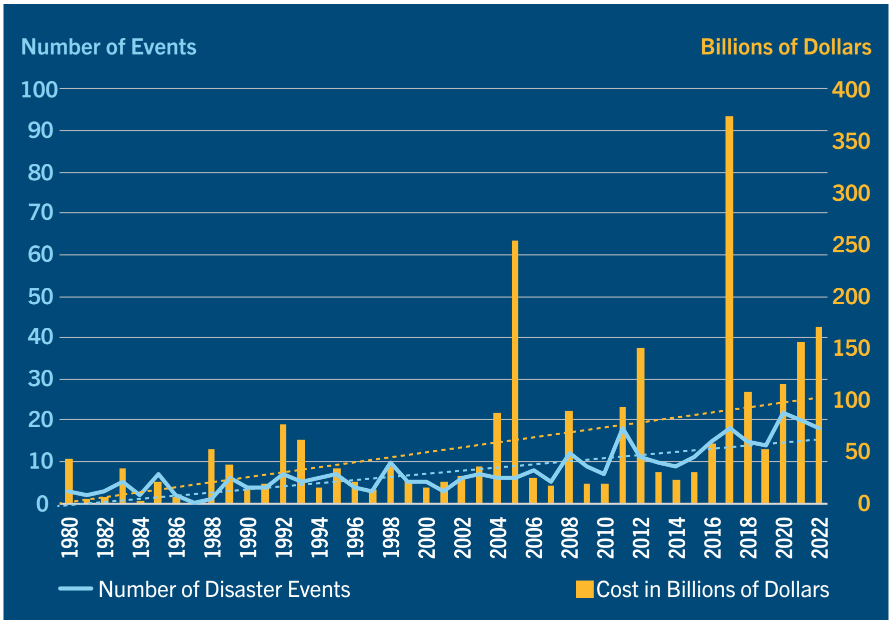


EXHIBIT 1: United States Billion-Dollar Disasters By Year (CPI-Adjusted)



Source: NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2023). Disasters include drought, wildfire, floods, winter storms, freezes, severe storms and tropical cyclones.

cover grain elevators, input storage and other industrial facilities. This report does NOT address the impact of recent California wildfires on specialty crops, nor the impact of weather and drought on producer losses that are insurable and covered under the Federal Crop Insurance program.

Analysis

Impact of Recent Catastrophic Losses to the P&C Industry

Over the past three years, cooperatives and their P&C insurers have faced a perfect storm of excessive property losses due to natural catastrophic losses coupled with the need to repair physical structures using expensive building materials and higher costs construction laborers.

According to both NCEI and the National Oceanic Administration (NOAA), natural catastrophes in 2022 caused an estimated $170 billion of losses, compared to $155 billion in 2021 and $114 billion in 2020.

The impact of last year's catastrophic events resulted in a $26.5 billion statutory underwriting loss for the U.S. P&C industry, according to rating agency A.M. Best & Company, which was 23% worse than 2021's underwriting loss of $21.5 billion.[2] And while insurance carriers have been raising rates for the past two years in response to rising claims, the pace of rate increases has failed to offset the cost of claims. The culprit? Labor and basic materials inflation.

Despite the staggering size of natural catastrophic losses in recent years, the U.S. P&C industry maintains strong levels of liquidity (with estimated industry capital of $980 billion at Dec. 31, 2022), enabling it to pay claims to agricultural cooperatives and other customers. However, when losses outpace the P&C company's investment earnings, the insurer makes up the difference by passing on the additional "loss costs" to the customer (i.e., the GFS cooperatives). Warren Buffett summarized how a P&C makes money: "The insurance business produces float, created by the premiums paid by those purchasing insurance. The insurance company gets to invest the float until the insurance claims are made."[3]

Note that in an environment of increasing claims as we have recently seen, underwriting profitability breaks down. The P&C insurer must continually increase prices to achieve rate adequacy.

Impact of Recent Trends for CoBank Customers

A combination of factors – namely the withdrawal of reinsurance capacity and the exit of one Midwest player (Austin Mutual, a subsidiary of American Family Insurance) – is making an already difficult situation more difficult for ag cooperatives. Post Austin Mutual, six principal players provide property insurance to U.S.

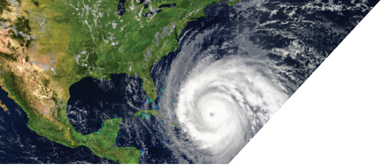
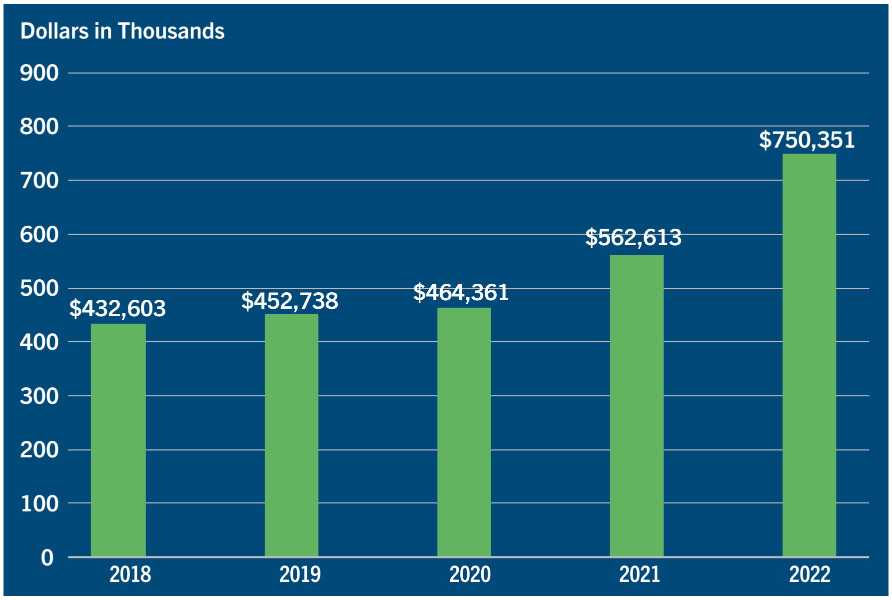


EXHIBIT 2: Total Average Insurance Expenses for CoBank Grain and Farm Supply Customers



Source: CoBank, ACB

ag cooperatives: Nationwide Agribusiness, Triangle, Continental Western Group, Chubb Agribusiness, Berkley Agribusiness, and Crum & Forster.[4]

To assess what these changes could mean for CoBank cooperative customers, we conducted external and internal analyses. For our external analysis, we informally surveyed insurance brokers and insurance carriers and found that U.S. agribusinesses paid 40% to 60% more (risk-adjusted) during the 2023 renewal season (both January and April). Those customers that experienced property losses during 2020 to 2022 saw rate increases of 40% to 100% and even more for certain customers located in Minnesota and North Dakota. Beyond paying higher rates, cooperatives are also bearing higher deductibles – often growing from $50,000 to $250,000 or five times previous retention levels – along with reduced coverage limits and tighter terms and conditions.

For our internal analysis, we collected and aggregated insurance and total operating expense data from U.S. GFS cooperatives that borrow money from CoBank. Our sample size averaged 293 such borrowers during the five-year period studied (2018 to 2022.) Our analysis corroborated what we learned from our external conversations with insurance industry participants:

1. Total insurance expenses for the average CoBank GFS cooperatives started rising meaningfully after 2020 *(Exhibit 2).*
2. Insurance expense growth has outpaced total operating expense growth by a wide margin since 2021 *(Exhibit 3).*

Potential Strategic Responses

CoBank believes that the commercial property insurance market will remain firm over the next 18 months, meaning that GFS cooperatives will continue dealing with a trifecta of costlier insurance premiums, higher deductibles and restrictive terms and conditions. While there is no silver bullet solution applicable to all cooperatives, we have identified five strategic options for companies to consider in order to mitigate rising insurance costs. We see two options as the most relevant and actionable. We note that any option should be evaluated only in consultation with competent accounting, legal and risk management advisors.

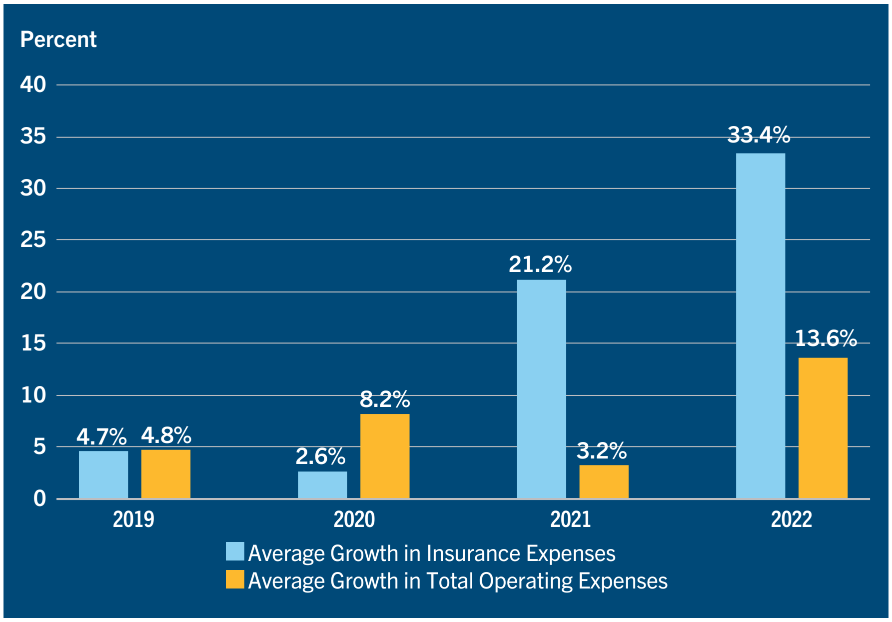
Upgrade Infrastructure

The theoretical case for modernizing property, plant and equipment to better "weather" catastrophic events makes sense. Unfortunately, the timing for making capital expenditures is not ideal as benchmark interest rates are 500 basis points higher today than at the beginning of 2022. Therefore, this strategic response may not offer a compelling return on investment strictly to help reduce property insurance expenses.

Form a Captive Insurer

A captive insurance arrangement entails forming an insurance subsidiary that provides risk management and mitigation services to a parent organization, when traditional insurance coverage is either unavailable, unaffordable or otherwise not ideal. Based on our discussions with Marsh & McLennan, one of the world's largest commercial insurance brokerage firms, and

EXHIBIT 3: Expense Growth Rate Comparison of CoBank Grain and Farm Supply Customers



Source: CoBank, ACB

Important note: Although it was not possible to strip out what portion of insurance expenses were solely attributed to property coverage programs (or alternatively, total property/casualty insurance expense), we believe the data is still meaningful for time-series trend analysis.

Triangle Insurance, a cooperatively owned and managed insurer, we learned that captives typically make sense only for large organizations. For the captive to endure financially and justify the large upfront formation costs, it needs to gain critical mass and geographic diversification and employ staff to handle premiums and process claims. For property insurance, additional challenges for a captive include difficulty in achieving diversification and costly staff who have the required specialized expertise to model catastrophe risks (using advanced computer simulation) and negotiate reinsurance contracts.

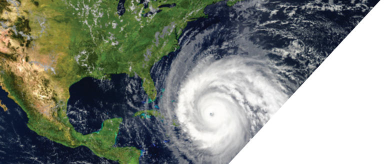
Participate in a Risk Retention Group

Risk Retention Groups (RRGs) are insurance companies owned by its members.[5] RRGs allow businesses in the same industry that have similar needs "pool" their risks into a special purpose insurance company (and thereby obtain coverage for those risks). This type of insurance program (which can be organized either under the Federal Liability Risk Retention Act or in compliance with state insurance laws) can be thought of as an insurance cooperative arrangement. While RRGs have been tried before in the GFS cooperative space (one such arrangement a few years ago involved three cooperatives in Nebraska, South Dakota and Iowa), the concept proved challenging in practice. In short, if only one party has a loss during a given year, the other two parties end up funding their pro-rata portion of the claims and thus, may fail to meet the program goals as stated to the board of the impacted cooperative. (Said differently, not having a loss but having to pay for someone else's loss does not sit well with most cooperative boards.)

Improve Internal Loss Control

Improving risk and hazard identification and monitoring should be an ongoing part of every company's internal risk management function. Our research found that cooperatives may be able to reduce property insurance program costs by deploying better operational, field and logistical analytic software, aka leveraging next-generation remote sensing, data gathering and decision technologies to enhance internal risk management. Ag-tech and fin-tech companies can provide portfolio-level risk management solutions.

To quote Jim O'Brien, CEO of Wisconsin-based ag fin-tech firm, Agrograph, "Having a complete view of your portfolio – whether monitoring physical assets like storage bins or building or the performance of commodity crops like corn and soybeans, with the ability to visualize, report and validate portfolio performance at a granular (field level) – is the difference in receiving more favorable cost of capital from your insurance company, or your investors."



By being able to document improved risk management, the cooperative should be able to negotiate insurance coverage that more closely aligns to exposure ratings as opposed to broader industry loss experience-driven rate increases.

Purchasing Coverage via Hybrid Insurance Program

The final option is to participate in a hybrid program created and managed by a specialty insurance carrier or broker that blends the benefit of a traditional program with certain benefits of both traditional and non-traditional insurance. What this means is that the agricultural cooperative can enjoy having more control over its deductibles, coverage limits and direct loss control activities, while limiting the upfront costs of setting up a captive. We have learned of at least three such arrangements available in the marketplace today, offered by Triangle Insurance (a cooperatively-owned carrier) and Lockton Companies and Marsh & McLennan, two leading international insurance brokerage firms.

Conclusion

For the past two years, GFS cooperatives have seen an increase in commercial P&C premiums, and more restrictive terms and conditions, which CoBank sees continuing over the next 12 to 18 months. The situation has emerged due to a trifecta of more frequent and severe natural catastrophic losses: a function of the interplay of climate change driven weather volatility, rising property values and higher costs for assets that are damaged due to inflation in building material costs and labor. This report identifies five strategic responses for GFS cooperatives to evaluate in order to mitigate rising insurance premiums. We see two of these options – improving internal loss control and purchasing property insurance through a hybrid insurance program – as the most relevant and actionable for CoBank's customers.

Endnotes

[1] "2023 US Tornadoes," Center for Disaster Philanthropy, 19 May. 2023. https://disasterphilanthropy.org/disasters/2023-us-tornadoes/

[2] "A.M. Best's Special Report: U.S. Property/Casualty Industry Suffers $26.5 Billion Underwriting Loss in 2022," AM Best news release, 22 March 22. 2023. https://news.ambest.com/newscontent.aspx?refnum=248590

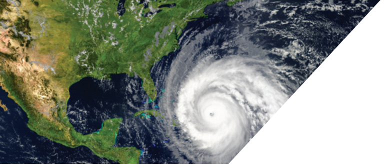
[3] Stone, Bill. "Highlights from Warren Buffett and Berkshire Hathaway's 2023 Annual Meeting," Forbes, 7 May. 2023. https://www.forbes.com/sites/bill_stone/2023/05/07/highlights-from-warren-buffett-and-berkshire-hathaways-2023-annual-meeting/?sh=ede499674fa1

[4] Marsh & McLennan and Triangle Insurance, May 31, 2023.

[5] "Risk Retention Groups," National Association of Insurance Commissioners (NAIC), Center for Insurance Policy and Research, 7 Feb. 2023. https://content.naic.org/cipr-topics/risk-retention-groups#

Glossary of Select Insurance Terms

TERM	DEFINITION
Actual Cash Value	Repayment value for indemnification due to loss or damage of property; in most cases it is replacement cost minus depreciation.
Attachment	The attachment point is the loss level at which excess insurance or reinsurance limits apply.
Business Interruption	Business income coverage (BIC) is commercial property insurance covering loss of income suffered by a business when damage to its premises by a covered cause of loss causes a slowdown or suspension of its operations.
Captive Insurer	An insurance company established by a parent firm for the purpose of insuring the parent's exposures.
Catastrophe Loss	A large magnitude loss with little ability to forecast.
Commercial Property	A commercial property policy is an insurance policy for businesses and other organizations that insures against damage to their buildings and contents due to a covered cause of loss, such as a fire.
Deductible	A per-loss deductible specifies the amount of first-dollar loss paid by the insured for each loss.



Glossary of Select Insurance Terms (Continued)

TERM	DEFINITION
Excess & Surplus	Excess and Surplus Lines ("E&S") insurance coverage is designed for businesses with uniquely high risks that are not covered by traditional markets.
General Liability	The commercial general liability (CGL) policy is a standard insurance policy issued to business organizations to protect them against liability claims for bodily injury (BI) and property damage (PD) arising out of premises, operations, products, and completed operations; and advertising and personal injury (PI) liability.
Loss of Use Insurance	A policy providing protection against loss of use due to damage or destruction of property.
Parametric Insurance	Parametric insurance is a non-traditional insurance product that offers pre-specified payouts based upon a trigger event.
Peril	Is the source or cause of loss including, but not limited to, fire, lightening, business interruption, loss of rents, glass breakage, tornado, windstorm, hail, water damage, explosion, riot, civil commotion, and rain.
Property Insurance	Coverage protecting the insured against loss or damage to real or personal property from a variety of perils. Note that property coverage for cooperatives is often provided on a replacement cost value basis rather than actual cash value.
Replacement Cost	The cost of replacing property without a reduction for depreciation due to normal wear and tear.
Risk Retention Group	Group-owned insurer organized for the purpose of assuming and spreading the liability risks to its members.
Reinsurance	Reinsurance is transaction between a primary insurer and another licensed company where the reinsurer agrees to cover all or part of the losses and/or loss adjustment expenses of the primary insurer. The assumption is in exchange for a premium. Indemnification is on a proportional or non-proportional basis. Non-proportional Reinsurance - reinsurance that is not secured on individual lives for specific individual amount of reinsurance, but rather reinsurance that protects the ceding company's overall experience on its entire portfolio of business, or at least a broad segment of it. The most common forms of non-proportional reinsurance are stop loss and catastrophe.
Self-Insurance	Type of insurance often used for high frequency low severity risks where risk is not transferred to an insurance company but retained and accounted for internally.
Umbrella Coverage	Umbrella insurance refers to liability insurance that is in excess of specified other policies and also potentially primary insurance for losses not covered by the other policies.
Workers Compensation	Workers compensation is the system by which no-fault statutory benefits prescribed in state law are provided by an employer to an employee (or the employee's family) due to a job-related injury (including death) resulting from an accident or occupational disease.

Source: Insurance Risk Management Institute, National Association of Insurance Commissioners

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