

The Need For Improved Risk Management



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It is finally official, we are in a recession. According to the National Bureau of Economic Research, the economy has been in a recession since last December. Most folks thought this was the situation, but it takes time for the official measurements to be taken and confirmed.

In addition, our economy is suffering through multiple crisis situations in the housing and financial sectors. These are tough times in our economy. Agriculture has not been heavily impacted by these problems. In fact, crop producers have been doing pretty well the last two or three years due to high product prices. The last year saw crop input prices increase dramatically and reduce margins substantially.

The high prices which have been so beneficial to crop producers have been disastrous for livestock producers. The extent of this situation was reflected recently when one of the nation's largest poultry integrators declared bankruptcy. Managers of the business said it was a combination of high feed prices and low poultry prices resulting from too much chicken on the market.

Another characteristic of the current conditions in Agriculture is the increased volatility of all prices resulting in increased uncertainty for everyone involved in the industry. The ethanol based increase in the demand for corn combined with worldwide production problems with various commodities has resulted in unprecedented increases in grain prices during the past couple of years. It all culminated with extremely high prices this summer. Since June, corn, soybeans, and wheat contracts have fallen by half. We have also seen a similar decline in fuel prices. However, other agricultural inputs have not fallen to the same extent. There are indications that fertilizer prices have started to "back-off," but nothing like the drop in crop or fuel prices. Seed and chemical prices have not come down and there are few indications they will.

Return of the Cost-Price Squeeze

These developments indicate that we may be returning to the familiar cost-price squeeze conditions with which farmers are quite familiar. If input prices remain high and crop prices remain relatively low then this will put great pressure on margins and force many producers into a situation where they have difficulties producing products at break-even prices.

A unique aspect of this renewed cost-price squeeze is that it will occur at a much higher level of costs than in the past. This presents a much greater potential loss. These higher production costs also increase the amount of operating capital needed to finance crop production, again increasing the potential risk faced by the crop producer.

At this point we may begin to see the implications on Agriculture from problems plaguing other sectors of our economy, namely the financial and housing problems. While Agriculture is in a relatively strong financial position and not in a situation similar to the conditions that existed during the Financial Crisis we experienced during the late 1970's and early 1980's. Agriculture may still experience repercussions from the problems plaguing other sectors of our economy.

Lenders will likely tighten up their lending practices and procedures. They may require more security or collateral and better documentation for loans. Further, they may be less willing to extend as much credit per productive acre as needed since that would increase their risk exposure. Lenders may also increase interest rates on operating loans to cover their greater risk exposure.

Improved Risk Management Required

All of these developments point to a greater need for improved risk management and possibly a bit of a different way of looking at risk management. The first thing that should be considered as part of your risk management strategy is crop insurance. However, you should consider going beyond the more traditional yield protection offered by crop insurance. There are a variety of possible crop insurance products available and crop producers should acquaint themselves with the newer Revenue Insurance plans which address both yield and

price risk. Given the tremendous volatility we have experienced in the recent past, you may want to address the price risk exposure. Also, livestock producers should consider the possibility of using a crop insurance policy if there is a product available to fit their specific needs. The same can be said for dairy farmers.

Another aspect of your risk management program should be some consideration of a marketing plan and the possible use of some type of forward pricing mechanism. Forward pricing used to be a very standard part of any suggested risk management program. However, one must approach this alternative with a bit of trepidation. Recent problems with the wide basis and failure of contract prices and cash prices to converge have made this option a much greater concern than in the past. Wheat producers that experienced a \$2.00 basis with wheat contracts this past summer can attest to the problems such risk management measures introduce into the risk profile of the wheat production business.

You should also know those folks you do business with very well. Do not be afraid to inquire about the financial position of the businesses you depend on financially. Grain elevators and other agricultural supply firms have been experiencing financial problems resulting from the volatile market prices as have farmers. They may not be able to survive these tough times. How would the financial failure of a business you work with impact your farm business? An example of this occurred recently in Iowa when Verasun Energy, the nation's largest ethanol producer declared bankruptcy in October. Their bankruptcy left many farmers and elevators in peril because they had contracts to sell corn to the business.

Liquidity management should also be a part of your risk management program. The financial crisis in the general economy will have agricultural lenders viewing loan applications with a critical eye. Farm businesses will need better financial documentation than in the recent past. This will likely include the need for a Balance Sheet, an Income Statement, and a projected cash flow of the business. Your farm business should place an emphasis on building a credit reserve to be used as the need arises.

Another aspect of liquidity management you should consider is building and maintaining greater cash reserves. These cash reserves can be used should you experience problems obtaining operating credit. This should also help to keep interest costs down. Now may be a great time to repair, recondition, and repaint your equipment rather than replace with new equipment.

Enterprise budgets may not necessarily be thought of as a risk management tool, but they should be an integral part of the general management of your farm business. They may be of increased importance in the coming year. Consider which enterprises you should produce next year and build an enterprise budget for each enterprise. Project product prices and input costs the best you can and compare the expected results. We have a number of enterprise budgets available on the Web that might be helpful in this process. They are available at: [HYPERLINK "http://www.ca.uky.edu/agecon/index.php?p=29"](http://www.ca.uky.edu/agecon/index.php?p=29) <http://www.ca.uky.edu/agecon/index.php?p=29> The budgets have been recently updated to reflect current economic conditions; however you should download the budgets and update to reflect your specific situation. Further, you should follow developments concerning price and cost changes as they occur and update your budgets as needed. Continue to do this until planting time. Make your best effort to keep current information reflected in the budgets and make the best decision you can under the circumstances.

These various attempts to improve your risk management program should help your farm business survive and prosper in the future. If you would like more information about general risk management, the USDA's Risk Management Agency has an online resource you can easily use to help improve your knowledge of risk management. It is available on the Web at: [HYPERLINK "http://farm-risk-plans.usda.gov/"](http://farm-risk-plans.usda.gov/) <http://farm-risk-plans.usda.gov/> Δ

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