



## Risk Assessed Marketing

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**Disclosure:** Dr. Barnaby's research was the basis for the privately developed Crop Revenue Coverage.

### **LIVESTOCK RISK PROTECTION – A NEW INSURANCE CONTRACT FOR CATTLE<sup>1</sup>**

The Risk Management Agency (RMA) has announced the release of the Livestock Risk Protection (LRP) contract for Kansas on feeder cattle. This new contract was released in early June but has many differences from the typical crop insurance contract that is re-insured by the RMA.

**LRP does not guarantee the producer a cash price.** The LRP contract is a single peril price risk contract. Effectively, it is an off board price derivative but for legal reasons it is referred to as an insurance product. Effectively, the way LRP works if a producer buys an \$80 per hundred weight guarantee and the market as measured by the Chicago Mercantile Exchange (CME) feeder cattle price index drops \$10 per hundred weight then the producer would receive an indemnity payment equal to \$10 per hundred weight times the total target weight of the livestock insured (less premium). If the producer sells the cattle in the cash market for \$70 per hundred weight then effectively the producer did achieve the \$80 guarantee. A producer received a \$10 indemnity payment plus \$70 per hundred weight in the cash market, for a total of \$80 (less premium). However, if the producer sells the cattle for \$65 in the cash market then his/her total revenue is \$65 from the cash sales plus the \$10 indemnity payment for a total of \$75. **This LRP contract does not guarantee the basis.** Therefore, one only has a total price guarantee if the cash selling price equals the CME index cash settlement value as reported on their web site.

**Purchase of an LRP.** Producers must first submit an application for an LRP contract. This application establishes the eligibility for the producer to purchase the LRP insurance contract. The primary condition is the producer must have a substantial beneficial interest in the livestock before they are eligible to purchase the LRP contract.

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The LRP contract receives a 13 percent premium subsidy and the administrative and commission expenses are also paid by a separate subsidy. In a private insurance market one would not receive any premium subsidy and the purchaser would also have to pay for the administrative and operating cost of the insurance contract.

Not all insurance companies are writing the LRP contract. In addition, many insurance agents are not writing the LRP contract. Therefore, producers will need to locate an agent who is writing the LRP contract.

Once the person has located an agent that has been certified to write the LRP contract they will need to submit an application. Once the application has been accepted then the second step is the producer will need to submit a specific coverage endorsement (SCE) to initiate the LRP coverage on feeder cattle.

Producers must identify the number of feeder steers that are expected to be ready for market at 650 to 900 pounds. The producer would then choose the appropriate insurance period to reach the target weight ranging from 21 weeks to 30 weeks.

The producer will then select a coverage price for the period of the policy. The insured value will equal the number of head times the target weight times the coverage price times the ownership share. The total premium will equal the insured value times the rate. The 13 percent subsidy is then subtracted.

The SCE must be submitted on line to RMA, which gives the specific dollar per hundred weight guarantee and premium cost incurred. There are two reasons for this requirement. First, the guarantee and the premium cost vary daily. In addition, RMA has a limited amount of coverage that can be sold under the LRP contract. Therefore, once all of the liability/coverage has been sold no more contracts can be issued. However, if the demand is great enough to exceed the coverage allocated to this program, it will be interesting to see if Congress and the USDA decides to make more funds available for the LRP.

Producers may have multiple SCE's. In effect, they can buy the SCE coverage on parts of their herd over a period of weeks. Because the price guarantee and rates changed daily, it would not be unreasonable to expect producers will have several SCE's on shares of their livestock. Once the SCE is submitted through the RMA web site, the contract is approved and coverage will attach. Producers will then owe premium once coverage is confirmed.

**LRP States.** The feeder cattle contract is available in Kansas, Colorado, Iowa, Nebraska, Nevada, Oklahoma, South Dakota, Texas, Utah, and Wyoming. The fed cattle contract is available only in Iowa, Illinois and Nebraska. However, it is possible for Kansas producers to purchase a fat cattle contract if they are feeding the cattle in a Nebraska feedlot. What determines the eligibility for an LRP on fed cattle is the location where the cattle are being fed, not where the owner lives. The fed cattle contract is limited to 2,000 head per SCE although one may purchase an SCE with fewer head and a maximum of 4,000 head per crop year. Crop year is defined as July 1 through June 30. The feeder cattle LRP is limited to 2,000 head per crop year and 1,000 head per SCE.

**Length of LRP Coverage.** LRP has been approved for SCE feeder cattle coverage s in 30 day increments from 13 weeks to 52 weeks. While the SCE for feeder cattle is authorized for up to 52 weeks, when checking the RMA web site, the current offer is a maximum of 30 weeks. Currently, the rating model used to set the LRP rates does not have sufficient data to rate

contracts for a longer period of time. RMA is aware of this situation and has been looking at other rating methods that could possibly allow for coverage over a longer time frame. The longer time period would probably fit cow-calf producers better where they typically retain calves through weaning and backgrounding.

**Market for LRP.** This contract may be very attractive to certain classes of producers over a CME feeder cattle put contract. Producers may buy LRP only on the number of head they actually own and that may be fewer head than would be required for a CME contract. For example, if a full CME feeder contract represents about 80 head but if the producer only has 50 steers then they would be able to purchase LRP on just the 50 steers. Also, this is an insurance contract because once purchased it can not be cancelled as can be done with a put option. Because it is an insurance contract with a specified insurance length it will be attractive for lending institutions who are lending money on cattle serving as collateral.

Potentially this contract could also provide additional interest simply because producers may insure the cattle for further out months. That would be especially true if RMA makes changes to the rating methods so that one could actually purchase a 52 week contract. The longer insurance time period would allow farmers to cover the price risk for the entire length of time they hold the cattle. This would be especially attractive for cow-calf producers.

Because it is an insurance contract there is also no question that it is a tax deductible expense and would be included as a farm expense item. Options are also a tax deductible expense although some trading strategies sometimes are not considered deductible expenses.

One major advantage of the LRP is the 13 percent premium subsidy and there is no commission paid by the producer. The insurance agent commissions and operating expenses of the insurance company are all funded from a separate line item in the RMA budget.

**Moral Hazard or Adverse Selection.** There is little chance of moral hazard or adverse selection in the LRP contract simply because the contract is not tied to the individual's production level or price received. The payment is triggered totally on a market decline and that will affect everyone who has bought an LRP contract. For example, if 50 people purchased a 30 week contract today and the market declines by \$10, they would all receive a \$10 indemnity payment assuming they bought the same coverage level.

The number of head and the target weight are simply a way to determine eligibility for the contract. RMA does not want non-livestock producers purchasing the LRP contract because this is a subsidized product. Therefore the calculations used to determine the weight and the number of head are simply to verify LRP purchasers actually owned that number of head of cattle and approximate weight that was certified in the application.

**Limitations on LRP.** Currently the LRP is not available on heifers or breeds containing significant amounts of Brahma or dairy genetics. The other limitation on the LRP contract is that producers are not allowed to take an offsetting position in the futures market. For example, they buy an LRP contract on their cattle and then write a put option on CME. Clearly, this is probably an unenforceable underwriting rule simply because farmers could write the put option on their cattle that they do not have a SCE or they could simply open a speculative account.

Probably this underwriting rule effectively prevents marketing consulting firms from marketing their service to producers on how to extract the subsidy from the LRP contract. Remember this is suppose to be a risk management protection tool that will reduce the negative effects on

producers' revenues caused by declining prices. In addition, most lenders who are financing cattle want the protection. They don't want producers simply extracting the subsidy because the subsidy is a very small amount of the total dollars at risk in a livestock operation.

**The other major question is the rate fair?** One would probably want to compare the premium cost of the LRP versus a premium cost of a CME put option. Future K-State analysis will analyze the rating of the LRP contract. The LRP contract premiums will be compared primarily with the CME put options but one must also remember the LRP contract is effectively a European put. There is no right to exercise an LRP nor can one cancel the LRP after it has been purchased. Producers have also voided the contract if they have simply taken an offsetting position on the CME, even if it is unlikely that this underwriting rule can be enforced. In any case it is not recommended that a producer will buy an LRP for the sole purpose to write puts against that LRP in order to extract the premium subsidy. The premium subsidy of 13 percent is a fairly small amount of the dollars compared to the price risk protection that is being covered.