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Margin Account Risk, Who Knew?¹

Sara Wyant and Sarah Gonzalez in the Agri-Pulse publication have an excellent story on the MF Global hearings. She breaks the story down so even I can understand it. This story is one that many people probably should take a minute and read.

This MF Global debacle is really a big deal, and probably more important to farmers than the Farm Bill. If the regional banks (not too big to fail) and Farm Credit system lose confidence in the marketing system and view those hedge accounts as having risk from unauthorized use, then the whole marketing chain is in trouble. Elevators need margin money to manage the price risk for stored grain.

If the collateral and interest rates increase to cover the perceived risk in margin accounts, then elevators (grain buyers) will need to widen their margins. Bottom line, higher marketing risk means lower cash bids than otherwise would be the case. Farmers who have never used futures will be affected in the cash market if this problem is not fixed. Many farmers are very angry about the fund losses in their hedge fund accounts and have stated they will never do business with the CME again! It is a little like loss of money from one's checking account; one just doesn't expect that to happen, so these farmers have a right to be mad. However, that will not fix the problem and the grain will be

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hedged by the elevators and other grain buyers, so all grain farmers will be doing business indirectly with the CME.

In the past those hedge accounts were viewed as cash and not at risk from unauthorized use. Two years ago in wheat country, margin account lenders become nervous over the lack of convergence between cash and futures that affected the short hedge of elevators. One would doubt that the latest news has calmed their nerves. Many small banks were willing to provide margin loans to farmers with Revenue Protection crop insurance coverage because they did not view those margin accounts as funds with risk from unauthorized use.

What caused the problem? In the past clearing houses were allowed to invest separated customer funds in low risk US Treasury bonds. Currently the rate of return on US T-Bills is very low. A few years ago, the Commodity Futures Trading Commission (CFTC) approved a rule change in regulation 1.25, which limits the type of security investments for which a firm can use customer funds. It appears that the regulations now allow separated customer funds to be invested in assets other than US Treasuries, such as European bonds. Because US Treasuries have very “low” rates of return, MF Global decided to invest in higher rate bonds, such as those from Greece, and leverage the whole deal. Like the housing market, once the value of the underlying asset value declined it all fell apart. It is likely that new CFTC regulations will change rule 1.25 to limit investment in “risky” foreign government bonds. With lower leverage ratios, the foreign investment would have unlikely caused a problem had they invested in German bonds but those yields were lower. It appears that the financial issues are muddy enough that MF Global officers did not break the law with their “risky” investments. The CME Chairman’s comment on breaking the law is limited to not keeping the funds separated.

The CME chairman testified that significant changes occurred a few days before MF Global failed because previous records showed preserved customer accounts. He stated that in their opinion, somebody broke the law. Kansas cattle rancher, Tim Rietzke agrees with the CME that a law was broken in his interview with NPR radio on the loss of his MF Global margin account. He has a more blunt way of saying “unauthorized use of his margin account”. The link to this short radio interview is at:

<http://www.npr.org/player/v2/mediaPlayer.html?action=1&t=1&islist=false&id=143727507&m=143729051>

The text of the interview can be found at:

<http://www.npr.org/2011/12/14/143727507/rancher-discusses-losing-money-with-mf-global>

As one can tell with Mr. Blew and Mr. Hupfer’s comments below that were published in Agri-Pulse, even those farmers who have never used futures will be affected because the margin accounts are a cost of doing business as an elevator and will affect cash bids.

C. J. Blew, director of the Mid Kansas Cooperative Association, is still missing 64% of the association’s margin funds and excess cash since the collapse of MF Global. Blew said. “While we now have access to positions in our hedge accounts, only 36% of the initial margin funds needed for the transferred positions have been transferred to the new accounts.” He added that the MF Global bankruptcy impacted the cooperative’s

borrowing base, since missing funds cannot be used as collateral. “We must assure sanctity of segregated customer funds,” he said.

Roger Hupfer, a grain elevator operator in Michigan, said his customers place confidence and trust in their operation when delivering their commodities to the grain elevator. “They expect us to provide and maintain competitive, perpetual marketing programs to assist them with their risk management,” he said. “How will we be able to effectively manage the increased volatility and price risk, and place our hedges with confidence if the very integrity of exchange-based futures trading is in jeopardy?”

More regulations are often the first reaction to a problem. This is the lawyers’ response to problems and regulations will keep the “honest people honest” and clean the mess up afterwards. However, the CEO of the CME testified they were notified on Monday, October 31 that customer funds had been transferred to broker-dealer accounts in violation of CME rules. This suggests there were regulations but people in the MF Global firm chose to ignore the rules. If true, then it is difficult to understand how more regulations will fix the problem.

But most economists would suggest there are also economic incentives that could be used that will improve the efficiency of any regulations. Number 1 on the list is to make sure the bankruptcy laws puts margin account holders to the front of the line in bankruptcy court so they are paid first before anyone is paid, with no exceptions. This will create an incentive for investors, lenders, etc. doing business with a clearing house to make sure they are doing business with a firm that is solvent because they would only be paid after the margin account holders are paid. While bankruptcy law changes will not help current MF Global account holders, it would help future account holders. And more important it would reduce the risk on margin accounts and encourage better loan terms on margin loans for hedgers.

Congress has been investigating the loss of margin accounts. It is likely there will be additional regulations and changes to rule 1.25 but first we need to know why the CFTC and others missed this problem. This is where the story gets “muddy” because after reading the story many times it is not clear if this is the result of deregulation or if someone violated CFTC rules. In any case, one would hope that Congress will also get input from the Boards of Trade on what new regulations, if any, are needed. Currently the Senators and Representatives are all on the same page and it appears they agree this is a problem. The market needs a well thought out policy that will limit the possibility of margin account loss from unauthorized use or more precisely maintain segregated customer funds in the future.

Marketing Workshops for Farmers. In spite of these unforeseen risks, understanding the marketing and crop insurance system is still valuable information. Elevators have no choice, they will continue to use futures markets to manage their storage hedges. So farmers with no futures trading experience will be in a better position to understand their individual grain marketing risks if they understand the marketing system.

KSU has created a workshop for farmers and others who have no or only limited experience with futures, options, and insurance. This workshop will help growers to better understand today's headlines but more importantly to think about how to market next year's grain crops. Many farmers may find this workshop to be a good review even if they have been farming for many years. The object is to cover the basics. Surveys suggest most farmers have not used futures and the first day is targeted to this group. Even farmers who never plan to use futures should consider attending the first day because these markets impact the cash price that is received by growers.

While there are many farmers with futures trading experience, there are many with limited or no experience and this workshop is designed for you. A workshop titled; RAMI will focus on combining marketing and crop insurance for growers with limited experience trading futures will be offered on Thursday, January 26, 2012 8:30 am - 3:30 pm, Assaria Community Building, 315 E. Main St. Assaria, Kansas.

The second day is targeted to the advanced trader, i.e. farmers who have "lost money trading options". Any farmer who has met margin calls is probably ready for the second day workshop. The second workshop, titled RAMII, is designed for farmers and others with futures market trading experience and will be offered the next day, Friday January 27, 2012 at the same location.

These are two separate workshops and if a grower wants to attend both days they will need to register for both days. Tom Maxwell, Saline County Extension is taking registration. The first 30 people who register and send in their registration check will be enrolled. This is a new approach to reach those with limited understanding of futures markets and we don't know the level of interest but it is possible the workshop will fill early. So if one is certain they want to attend it is time to enroll now! To enroll or to ask enrollment questions, please contact Tom Maxwell at phone: 785.309.5850 or email at tmaxwell@ksu.edu. Program content questions can be sent to me or Dan O'Brien.