Stable Insurance: What are the Alternatives for Arable Farmers?

FORWARD CONTRACTS

There are several different types of Forward Contracts; a Fixed Price (or flat price) Contract is one of the most common. In a fixed-price Forward Contract, the farmer commits himself to deliver at an agreed time a certain quantity of crop of a specified quality. Normally, the farmer is only paid on delivery, although this type of contract can also be used to obtain pre-harvest financing. Premiums and discounts may be established for the produce that does not meet specified quality standards. The farmer carries the risk of losing potential gains when market prices rise.

Strengths	Weaknesses
• Easy to understand and simple to use. • No capital outlay needed. • Customised, giving the farmer flexibility over the quality, quantity and time of the transaction. • Local buyer. • Specific price established. • Growers are protected against price falls. • All costs are known at the time of contracting.	• Do not allow growers to take advantage of price rises. • After signing the contract, growers must deliver the grain as stated in the contract for the pre-determined price. • Due to the illiquid nature of these markets, contracts are inflexible and difficult to exit if needed. Calculation of washout costs are not transparent. • Growers are exposed to counter-party risk and buyers may default. • Prices often contain a weak implied basis, particularly early in the season. These basis levels often do not compensate the grower for taking on the delivery risk.

SELLING LITTLE AND OFTEN

This is where a grower will sell a proportion of their crop at regular intervals, regardless of market prices. For example, they sell a set amount at the end of each month, between the date of planting. The grower effectively hopes that they achieve 'higher than average' prices.

Strengths	Weaknesses
• Simple to do. • Smooths out the price received.	• Limits the ability to capture market highs.

Financial Promotion | +44 (0)203 859 9390 | hello@stableprice.com | 3 Whitehall Court, Whitehall, London, SW1A 2EL

FUTURES/ DERIVATIVES

A Futures Contract is very similar to a Forward Contract. It is an agreement to buy or sell a commodity of a standardised amount and quality during a specific month in the future, under terms established by the Futures Exchange, at a price established at the commodity Futures Exchange. These contracts are purchased through brokers.

Strengths	Weaknesses

• Liquid markets allow easy entry and exit from the market place.
• Price transparency as a result of publicly available Forward Price indicators.
• Ability to 'lock in' certain harvest prices for (part of) agricultural production.
• Flexibility to reverse a market position due to changes in crop growing conditions, condition of stored grain or price outlook.
	• Cost:
	  • Broker commission and fees.
	  • Opening an account with Broker.
	  • Potential for large and uncertain losses
	• Growers are exposed to Basis Risk between the Futures price and the 'ex farm' price they are trying to protect.
	• Standardised contracts cannot be changed to suit the needs of individual businesses
	• Futures are complex and require a significant amount of technical knowledge of the markets and regular information on daily price changes.

OPTIONS

A Futures Option Contract is a contract that gives the holder the right, although not the obligation, to buy or sell a Futures Contract at a specific price within a specified period of time, regardless of the market price of the Futures Contract when the option is exercised.

Options can provide the seller of a commodity with the security of receiving a minimum selling price. Whereas Options can protect the buyer from paying a maximum purchase price. Options can be therefore used to provide downside protection, while retaining some degree of upside potential.

An important difference between trading Futures and Options is that a Futures price is traded on the Futures Markets (like cash markets), while in trading Options, it is the Option premium that is traded.

Strengths	Weaknesses
• Possibility to gain from favourable price movements. • Limited risk with the only cost to the buyer being the Premium (i.e. no margin calls). • Growers can participate in favourable price gains. • Options safeguard against unfavourable price falls. • Increased flexibility and trading possibilities.	• Grade specifications and quality parameters applicable in delivering contracts, might not match that of the produce. • Expiration dates and specifications connected to contracts may not match cropping cycles. • Accessibility is a critical issue. Small-scale farmers might not have the scale to trade minimum contractual amounts of the exchange. • Limited capital may pose a problem in paying premium costs. • Technical issues, such as pricing Options and trading strategies involved in trading Options are complex.

POOLS

Pool Marketing is where growers, along with other famers/growers, commit an individual tonnage to create a critical mass which is marketed by a dedicated team of traders. There are different Pool Marketing options depending on a grower's movement and cash requirements. For example, the Harvest Pool is moved in August and September. Once grain is committed some Pools allow growers to access a range of pre-payment options to assist with cashflow demands.

STABLE

Strengths	Weaknesses
• Simple and flexible. • Sellers are not involved in the management of the Pool. It is instead undertaken by professional marketers. • Allows physical sales to be spread over a longer period. • Ability to take advantage of scale and negotiation for better prices from food companies.	• Due to the large size of Pools, the risk cannot be fully hedged. Hence the estimated returns can fluctuate until a Pool closes, which can be many months after harvest. • Pre-harvest Pools require growers to contract grain, which involves some production risk.

OVERDRAFT

A common indirect Risk Management Tool is the use of an Overdraft. This allows growers to take advantage of higher prices by delaying sales using the facility to manage the short-term shortfalls in their cashflows.

Note: A higher price for a later sale is known as the 'Carry' so the longer a grower can wait the more they can usually achieve for their crop.

Strengths	Weaknesses
• An Overdraft is flexible, you only borrow what you need at the time. • It's quick to arrange. • Normally no charge for paying off an Overdraft earlier than expected.	• Fees and interest payments cover the facility. • Extensions of an Overdraft usually require an arrangement fee. • Banks may charge for exceeding your Overdraft limit without authorisation. • Overdrafts may be secured against business assets. • Unlike loans, Overdrafts are only available from the bank where you maintain a current account. • Applied Interest rates are nearly always variable, making it difficult to accurately calculate borrowing costs. • Advantages of Carry does not take into account more fundamental movements in prices.

STABLE

Price volatility insurance for farmers. It protects agreed downside index price movements for arable, dairy and livestock products and upside price movements for a number of farm inputs.

Strengths	Weaknesses
• Reduced uncertainty. • Open to large and small farms alike. • Reduces the downside risk without limiting the upside if prices stay high or costs stay low • Protects a level of downside risk at an amount chosen by the farm. • Farmer can protect as little as 10 tonnes of crops or 10,000 litres of milk so its accessible to all farms • No ties to a single processor. • Cost are defined from the beginning. • An automated claims process, meaning quick pay outs at the end of the policy. • Underwritten by syndicates at Lloyd's of London for financial security	• To keep insurance premiums to a minimum, pay outs are made on conclusion of the policy.