Risk Management for Cattlemen

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Introduction:

Livestock insurance is a topic that is foreign to many in livestock production. In my presentation it is my goal to provide you with the basics of livestock insurance for cattlemen.

Overview:

Livestock insurance was first sold in 2002 and initially ran into problems as that pilot got underway. As the program evolved bugs were worked through and we ended up with two products that provide price protection for livestock producers at a reasonable cost. In this presentation I will review the two types of livestock insurance available and go through examples of when and where they are appropriate to utilize in your marketing scheme.

Livestock Gross Margin:

Livestock producers for decades have been without risk management tools other than the CME or CBOT. Livestock insurance came along in 2002 as a pilot program under the Agricultural Protection Act (ARPA). At that time they introduced Livestock Risk Protection (LRP) and Livestock Gross Margin (LGM) and were limited to hog producers, but were later offered to cattle producers also.

Livestock Gross Margin (LGM) can be used as a hedge against declining gross margin in finished cattle. This insurance is offered once a month, usually on the last Friday of the month and cannot lock in the subsequent marketing month following that LGM sales date. In other words the first marketing month available to purchase LGM contracts for the December sales period is February. There would also be 11 marketing months available each sales period since a producer is not able to lock in the nearest month to the sales date. The expected gross margins are typically posted by 5:00 PM the last Friday of the month (unless on a holiday) and must be closed and on the EDAS system by 8:00 PM the next day. Premiums are due when insurance is purchased and must be sent in timely with an application.

There are two types of LGM available to cattle producers. The first is referred to as “Calf Finishing”, which is made for producers starting feeder calves out at 550 lbs. to finish weight. LGM assumes a finish weight of 1150 lbs. The gross margin for both contracts are then calculated the same using the fat cattle price from the corresponding marketing month chosen

minus the feeder calf price minus the cost of corn (50 or 52 bu.). Below are examples of calf and yearling finishing:

Contract Type: Calf Finishing(500 lbs, 52 Bu, 1150 lbs):

Marketing period chosen: April 2014

Fat Cattle Price (April Live Cattle CME): $135.13 * 11.50 lbs. = $1554.00

Feeder calf price (August 2013 futures close CME): $154.62 * 5.50 = $850.41

Cost of Feed (Dec 2013 Corn CBOT): $4.29 * 52bu = $223.08

Gross margin insured: $1,554.00 –$850.41 –$223.08 = $480.51

Contract Type: Yearling Finishing(750 lbs,50 Bu, 1250 lbs):

Marketing period chosen: April 2014

Fat Cattle Price (April Live Cattle CME): $135.13 * 12.50 lbs. = $1689.13

Feeder calf price (August 2013 futures close CME): $164.60 * 750 = $1234.50

Cost of Feed (Dec 2013 Corn CBOT): $4.29 * 50bu = $214.50

Gross margin insured: $1,689.13 –$1234.50-214.50 = 240.13

*Examples were taken from actual LGM margin calculations for January 2014.

Choosing the marketing month is an important step in the process of locking in a margin. First, you should have a target month(s) for when the cattle you want coverage on will be ready for market. Second, choose a margin that is acceptable and makes the most sense for your operation. Third, choose the number of cattle you wish to cover and lock in that guaranteed margin with a livestock insurance agent.

While livestock gross margin guarantees a predetermined margin it does not cover death loss. If an indemnity is due, the producer is required to prove ownership showing marketings of at least 75% of the number of cattle insured to receive a full indemnity. If you are not able to verify 75% of the target marketings the indemnity will be reduced to the percentage of livestock the producer sold of the original target marketings. Indemnities are paid by the company after proof

of loss forms are completed and returned with sales receipts showing the sale of the insured steer and/or heifers.

Livestock Risk Protection:

Livestock risk protection (LRP) can be used to cover the market price of feeder cattle as well as fat cattle. Unlike LGM, LRP does not cover feed costs or the cost of the feeder calf. This product is priced much like a put option with the USDA subsidizing 13% of the premium.

LRP is available for purchase on feeder cattle and fat cattle, but only insures the market price of the cattle. LRP is available for purchase 5 days a week, but is the USDA's discretion. The prices are typically posted by 4:30 PM daily and must be locked in by 9:00 AM the following day. The expected ending value and actual ending value is set by the RMA using the Chicago Mercantile Exchange (CME). If the actual ending value is less than the guaranteed ending value an indemnity is payable under this plan. If an indemnity is due the producer will need to prove ownership with sales receipts or records of at least 75% of the cattle insured for that marketing period.

LRP is available in 13, 17, 21, 26, 30, 34, 39, 43, 47 or 52 week periods with multiple deductibles to choose from. When choosing the period a definite end date is specified and the actual ending value will be set on that day. Like LGM the producer should attempt to line up contract end dates when the cattle are to be marketed.

This product can be used by producers back-grounding feeder cattle or finishing fed cattle. If a producer does not feel it is necessary to insure feed costs this can be a good alternative to LGM when finishing cattle. This product is available more often than LGM and may need to be utilized if immediate coverage is needed.

Conclusion:

Livestock insurance should be used as a risk management tool and not utilized for speculation purposes. The products represented above provide a safety net for producers in case the market would move against them while in the production cycle. These products are attractive, because producers can insure by the head and not over or under hedge based on 40,000 lbs contracts. These products are a good match for producers of many sizes, but have maximum limits for large producers. Livestock insurance is underwritten and administered by the USDA and has the authority to suspend sales at any time.