ECONOMIC RESPONSES TO MARKET RISKS IN AGRICULTURE

edited by

Peter J. Barry and C. B. Baker

Proceedings of a Seminar
sponsored by Western Regional Coordinating
Committee-16 and Task Force 8 of NCRS-1
St. Louis, Missouri
November 13, 14, 1975

Peter J. Barry is Associate Professor of Agricultural Economics at Texas A&M University and C. B. Baker is Professor Agricultural Economics, University of Illinois at Urbana-Champaign.

FINANCING RISK RESPONSES OF AGRICULTURAL COOPERATIVES

Bernard Schulte*

Gentlemen, it's a pleasure to be here and talk with you. I hope I can add to this discussion of risk bearing in agriculture. As a representative for the Central Bank for Cooperatives my major concerns are with financing cooperatives and evaluating their role in providing marketing services as well as other functions for agricultural producers.

Cooperatives are concerned with providing sources of supply to producers at reasonable cost, marketing the producers' products, and providing other services. These are essential points. After all, a cooperative will not be organized unless it can provide at least one of these basic functions and thereby enhance the returns to its farmer members.

The Bank for Cooperatives' (BC) role is to finance effective and soundly conceived cooperative organizations. Judgment in evaluation of course enters in. We have legal and regulatory requirements set by the Farm Credit Administration that generally affect borrower eligibility and cooperative control. But from there on we are into the credit aspects of the cooperative.

The BC system is the smallest of the three parts of the Farm Credit System. We have between $3 and $4 billion in loans to farmer cooperatives that comprises about 60 percent of the total loans to farmers' cooperatives in the country. And the Central Bank has about 25 to 30 percent of total dollars loaned to farmers' cooperatives.

However, this large loan volume is not my reason for being here today. My role is to discuss our procedures for loan analysis and financial analysis

---

*Bernard Schulte is President, Central Bank for Cooperatives, Denver, Colorado.

of borrowing cooperatives because this is where we identify risk characteristics in these organizations. I will also consider marketing aspects because that is the kind of cooperative I've been affiliated with in California and Central BC finances a number of these.

How do we work with cooperatives in loan analysis? Analyzing their methods of risk management is quite important. What are the rights of the parties? What does a cooperative organization offer to the farmer? This is an important part of the analysis. Why does the farmer stay with the organization or in other cases pull away from it? To what extent do the cooperatives use budgeting and projections and what are the economic expectations of these organizations? What are their relative efficiencies? Under financial analysis, what is the repayment capacity, management effectiveness, member support, capital adequacy, etc.? The BC's work at this analysis job all the time. It requires special expertise, and has a high payoff.

In my experience on the west coast we began to see these risk and financial aspects in very stark perspective because the variation in economic conditions for speciality crops is so obvious from year to year. There may be a good market one year and no market the next year. As an example, consider the grape industry. Three or four years ago there appeared to be a shortage of wine in the country. As a result, grape production began to expand rather rapidly despite counsel by analysts against such large increases. The result has been excessive production much of which has had difficulty finding a market outlet. That's the kind of economic reality we hope to avoid in cooperative organizations. Frankly, I have seen a number of farmer cooperatives organized in the winery business with basic premise that they will then have a market available every year for their grapes, irrespective of price. That reason may be a less than complete means of justifying the formation of a cooperative, but it exists.

A cooperative's marketing options are difficult to analyze especially for

speciality crops whose market characteristics differ from those of the more general crops. But risk bearing by the farmer has to relate back to whether he is market oriented or production oriented. That old cliche is still relevant. This morning's discussion indicated that production efficiency doesn't necessarily assure good profits due to the workings of the marketplace. The long term risks also need to be considered.

In terms of the financial implications for a cooperative, one important consideration is how the cooperative establishes pricing and delivery conditions with its member-farmers. If the cooperative allows the farmer considerable flexibility through a long marketing period in trying to out-guess the market, he doesn't have much recourse to his cooperative if he believes they are doing an inadequate marketing job. I have worked with many cooperatives who have been reluctant to assume a large measure of the farmer's marketing function -- these cooperatives say it can't (or shouldn't) be done. However, this view has posed difficulties in financing in that lenders -- as an example, the BC's -- are reluctant to provide loan funds unless the cooperative can assure repayment capacity through greater expertise in management of the marketing function.

To integrate these financial and marketing issues, let me suggest a financial approach to cooperative planning. What are the kinds of financing that will be needed for the cooperative to effectively carry on the marketing function? First there is the capital program -- the financing of fixed assets or facilities. There is also the financing needed to carry on the operations of the cooperative -- obtaining the farmers' production at harvest or when he is ready to deliver and then selling the product on through the marketing channels. Operating capital needs depend upon the magnitude and timing of the cooperative's volume of business. Generally, the magnitude and timing can be reasonably estimated over the marketing period for the kinds of commodities that the cooperative handles. Hence, the fixed assets of the cooperative together with its projections

on operating loan requirements indicate the magnitude and composition of the cooperative's total financing needs in the near future -- that is, over the marketing period identified above. The largest amount of financing occurs, of course, when the peak volume of business is anticipated.

What kinds of financial capital are needed to meet these financing needs? We plan on the basis of both equity and debt capital. Equity is contributed by the members of the coop while the balance of financing is provided by borrowing. The portion of borrowing that is used to finance fixed assets will generally be term debt. The rest of the borrowing is operating debt or seasonal money.

Let's assume further, as is generally the case, that this is a buy-sell cooperative. That is, it takes title to the commodities sold by the farmer and must make payment to him. Hence, the cooperative must be ready to buy from the farmer when he is ready to deliver. At the time when business volume is greatest, the level of borrowing can be quite high relative to the cooperative's equity position -- leverage that may be excessive from the lenders point of view. How can the leverage be reduced? One approach is to seek additional equity to support the high level of borrowing. However, the farmer-members are often reluctant or unable to easily contribute additional equity.

There is another approach to this marketing-financing dilemmma that many marketing cooperatives have effectively used for many years. Suppose the cooperative takes delivery and title to the commodities in a manner that permits more orderly marketing. More orderly marketing in turn permits more effective financial planning that may avoid the very large swings in leverage through the buy-sell marketing. The effect is to diminish the seasonal peak in the cooperatives business volume thereby reducing the financing needed at that seasonal peak. The seasonal peak may have resulted, for example, in a 90 percent loan that stretches the equity too far. If the peak can be reduced, then the leverage is also reduced and the cooperative's equity better protected.

Marketing agreements can be made with the farmer-members to provide a partial payment upon delivery of the product at harvest that may amount to 50 or 60 percent of the expected net returns. Then, the farmer receives the balance of his returns when the product is later sold by the cooperative. The cooperative may pool the products of all their farmer-members for each commodity and sell frequently through the marketing period so as to stabilize the flow of returns. This averaging of cash flow over time puts less pressure on the cooperative's equity and is a far more bankable arrangement. In effect, this arrangement transfers part of the market risk back to the farmer but the pooling of product and averaging of returns may substantially reduce the risk for the individual members.

As I heard this morning, there is concern with the ability of the individual farmer to effectively and continually analyze the markets in order to fully carry the function of managing market risks. That is not unusual. In highly integrated operations where the farmer wants to carry his product beyond the gate of his own operation, he may have difficulty following the markets and making the best marketing decisions. Professional counsel is needed in analyzing the markets, following price movements, evaluating contracts and hedging opportunities, etc. This professional counsel is available and my point is that the marketing cooperative may be well suited to provide this service.

Two things are accomplished. First, the cooperative generally has limited sources of equity capital itself due to the need for its farmer members to effectively conserve and manage their own limited equity. Hence, equitable means of sharing risk between the farmer-member and his cooperative help to protect the financial resources of both parties. The farmer is directly interested in this risk reduction since he also owns the cooperative and will experience the ups and downs of its financial performance in his own business. This unique feature of the cooperative organization distinguishes it from noncooperative

kinds of business.

Farmer cooperatives that I am familiar with are highly involved in marketing agreements where they are asserting some leadership in industry operations, especially where the cooperatives are large and have a significant volume of the industry's total flow of production. Many cooperatives have their management and trained marketers on the commodity markets every day. They are doing the job of market analysis. They must have the farmer's trust and authority to carry on the market function; but on the average the farmer is going to get a better price. They may not capture the top dollar but this seldom occurs anyway. The cooperative can work for the farmer if he will relinquish much of the marketing function to a trained specialist. Pooling has much to offer and there are numerous kinds of pooling plans. From a banking standpoint, I believe pooling is highly desirable; nothing seems to disturb cooperative relations more than one farmer discovering that the cooperative sold his commodity at a lower price than his neighbor's.

Now let's return to the Bank for Cooperative's role. As our loan volume rapidly increased, our banks have insisted upon effective hedging, forward contracting to help set prices on a cooperative level and other means of effectively sharing risks with the farmer-members. All these practices help protect the cooperative's equity and thus make bankers happier. But the need for forward planning in the cooperative is as great if not greater than at the farm level. Bankers think in terms of security but I have worked with a number of large, unsecured loans. Security is often more a means of reassurance; if you have the right safeguards, then the banker can lend on a going concern basis. He wants the loan paid back. He does not want to foreclose. Neither does he want to finance a speculative kind of operation.

Our increased financing has forced us to look at the adequacy of our capital reserves and lending limits relative to the financing needs of some of the

larger cooperatives. Some of the large cooperatives are reaching levels of financing that may soon exceed our legal limits and we're looking for ways to syndicate these loans especially with large commercial banks. Liquidity in the banking system is an important feature to watch. I hoped that we have learned some lessons about liquidity from the credit crunches experienced during recent years. We are looking for diversification of our money sources. We are trying to make more effective credit decisions, including economic analysis. Applying these tools to very large, complex loans that characterize an increasing number of our cooperative customers is a challenging task. The Central Bank has about a hundred loans to the largest cooperatives in the country with $1 1/2 to $2 billion of loan volume and that's why we need all the help we can receive from agricultural economists.

What programs are needed to reduce risk? The export business is of growing importance. Our commercial agriculture is highly dependent on the demand provided by foreign trade to utilize all of our agricultural production. Hence, we must continue to carefully watch export operations. At the same time we are always looking for supply price information and experiment stations are quite important to us in providing this kind of information.