# Managing risk through hedging and options

**by Shirley A. Sokolosky**

The risky business of producing farm commodities is a tightrope act of Big Top proportions. That's why some banks are providing, and in some cases requiring, a safety net for their farm customers. The safety net is woven with a number of components, from comprehensive market planning and record keeping to using the futures market for hedging. While no one claims that these techniques are the total solution to the farm problem, they certainly seem to take a long stride toward bringing the profitability back to production.

Good record keeping is nothing new. The process of managing risk with those records is a fairly recent development, and one in which bankers have found themselves out of necessity. R.W. Allen, who heads R.W.A. Financial Services, a farm management service in Davenport, Iowa, says he's asked farmers if they could take 25 cents less a bushel for their wheat, and was greeted with a firm "no." "They don't have a floor price for their products," states Allen.

"I don't care if wheat is bringing $2 a bushel or $6," comments Allen. "You need a marketing plan and risk management regardless."

Emerging as a tool of choice for banks is calculated use of futures and options. Allen believes his experience in working with farmers shows that to have success in hedging, they need more than information—they need teamwork with a trusted adviser. "For about 15 years, farmers have been going to seminars where they spend $200 or $300 to learn about hedging," says Allen. "They often go away disappointed because it's an abstract concept and most farmers don't think in those terms. They just have to understand one concept—that they are selling something on paper they don't have—and that's difficult for them."

Allen comments that less than 5 percent of U.S. farmers hedge, either because

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they don't understand it, or because they've been burned by a bad experience. "Some farmers tried it, got a margin call, and said, 'this isn't for me.' "

Amidst the confusion, banks have begun to offer services to ease the way for their customers who wish to hedge and use options. The traditional route of calling a brokerage firm, which may have little agricultural expertise and empathy, has been joined by three new kids on the block—banks who have in-house brokerages, banks who serve as "introducing brokers" or intermediaries between farmer and broker, and marketing services who handle transactions and serve as advisers.

## The bank as brokerage

With $150 million in ag-related loans, Sovran Bank has a vested interest in the financial health of their farmer customers. That's why they offer a novel service—an in-house brokerage through Sovran Futures Corporation—to help their farm customers hedge their production bets. The $14 billion bank with 250 offices in Virginia, Maryland and Washington, D.C.,

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was cleared to offer this service by the Comptroller of the Currency in 1986. Stan Forbes, senior vice president and head of agribusiness, states that customers have been enthusiastic but cautious. "There have been instances in the past where brokers allowed their customers to get out of a hedge and into speculation." Forbes stresses that their service is strictly a protective one for the bank and its customers. Brokers are paid a straight salary, rather than a commission on each transaction. And in most cases, what is good for the customer is also good for the bank. "If we can help farmers maximize their profits, that means they can pay off their loan and the excess will be deposited with us." Adds Forbes, "It makes our portfolios much stronger if we know a customer will be bringing in X dollars this year."

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Cynthia Mullins, manager of Sovran Futures Corporation, says there are only a handful of services such as theirs, and that marketing their service has included educating their customers. "Local advertising hasn't been profitable, but we have exploited our relationships with commercial bank officers." Mullins says customers frequently comment that they should be hedging. "Our service is right there; consequently it's easy." Sovran signed up 25 ag customers their first year, and Forbes believes it has great potential for 1987.

Does Sovran's experience have application to your bank? Forbes believes a bank needs to be large enough to devote a division or department to the endeavor. "It's not the kind of thing a $25 million bank could justify. It's not something that one of your loan officers can do in addition to his other responsibilities."

Forbes hopes the future holds clearance for Sovran to handle transactions for some of its correspondent banks.

## Introducing brokers

For the bank who wants to be involved in its customers' marketing, but doesn't want to become a futures commission merchant, serving as an "introducing broker" may be the answer. Watseka First National of Watseka, Ill., became a representative for a Chicago brokerage firm in 1984, and to its knowledge became the nation's first introducing broker bank. Former vice president and trust officer Thomas Poskin says they thought it was important to help reduce price risk, but felt it would be important to maintain control from speculative trading.

"The last thing a farmer needs is more risk, and he certainly doesn't need leverage risk since he works on such a tight cash flow," says Poskin.

For its customers, Watseka offers the advantage of the farmer getting an education while using the benefits of the bank's other services. The bank can get a limited power of attorney and handle his margin calls. They can actually lend him the money to meet margin calls and purchase options. And, if he winds up with excess funds, they can be deposited in an interest-bearing account. "He isn't suffering the float with someone else taking advantage of his cash," states Poskin.

> ***"It is a risk reducer and service to our members."***
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> *Randy Woodley*
> *Farm Credit Banks of Texas*

Kerry Bell, vice president and chief ag lender, says the service is offered through a wholly owned subsidiary called WFNB Service Corporation. Bell declares customers have two options. With the first option, the farmer remains fairly autonomous. They do their marketing plan, place their own trades to the introducing broker and pay a fee per transaction. The second option, which Bell feels is the better option, includes assistance in developing a written marketing plan based on breakeven analysis. The bank monitors the markets and implements the trades when target prices are attainable. "This approach takes away a lot of the emotion involved with marketing as well as offering discipline."

The Farm Credit Banks of Texas are also testing the waters. Texas was involved in a pilot program from May 1986 through November 1986. Randy Woodley, director of research and new product development, says they had 35 members of Production Credit Associations (PCAs) sign up—15 actually used the service and four trades were averaged per member.

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Woodley believes that how the service is organized will vary depending upon desires of the local PCA. For the test, they used the loan officers they already had. The officers each took a week-long class and the required exam to become licensed brokers. Farmers paid an up-front fee annually, and each PCA set its own commission per trade.

"This is probably not going to be a big income producer for the association," says Woodley, "but it is a risk reducer and service to our members. We hope to cover our costs."

Such a system is fairly expensive to start, comments Woodley. "We had approximately $5,000 in out-of-pocket costs to test the service, and $20,000 was required as a minimum capital outlay. In manpower, Woodley says it took about 20 percent of two people's time.

Woodley believes this is an area that holds promise for his organization. "One way it can relieve some of the anxiety for farmers is they don't have to worry about margin calls. We take care of all that for them." Texas Farm Credit Banks will base the decision to expand the program on the interest of PCAs who did not participate in the initial pilot program.

## Market advisory services

R.W.A. Financial Services, Inc. has gone past simply providing market information to offering a complete farm management service for farmers, and much of this business has been done through banks. R.W.A. is an introducing broker as well as an advisory service, and has worked with 150 agricultural banks in the Midwest.

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> *R.W.A. Financial Services, Inc.*

President R.W. Allen states farmers can't learn hedging by reading a book. "They've got to get on the floor and dance." R.W.A. provides educational seminars as a starter and financial analysis and risk management packages to its clients. Vice President Jack Robinson says their success in working with banks stems from the fact that bankers hold the purse strings, and are now an integral part of meeting planning. R.W.A. has 125 independent farmers in its programs as well.

## How your bank fits in

The innovative practices of banks featured in this article are but the first wave of measures designed to put agriculture back in the black. While it's not meant to suggest you should become an introducing broker, use a marketing advisory service or offer an in-house brokerage, it is intended to spur your thinking about what "full service" really means.

You *can* affect what happens in your community, and the time is ripe to use the tools that are available. As R.W. Allen reminds us, "Isn't it amazing that the futures market was started in the late 19th century to help farmers lay off debt, and we're just starting to use them."

If you'd like more information about risk management, several publications are available. For a copy of "Risk Management Guide for Ag Lenders" write to: Chicago Mercantile Exchange, Offices Service Department, 30 South Wacker Drive, Chicago, Ill. 60606

The Chicago Board of Trade offers a variety of references. For a complete listing of those available contact: Chicago Board of Trade, Literature Services, LaSalle at Jackson, Chicago, Ill. 60604

For an information packet on marketing and risk management, write to: R.W.A. Financial Services Inc., 2224 East 12th Street, P.O. Box 3189, Davenport, Iowa 52808