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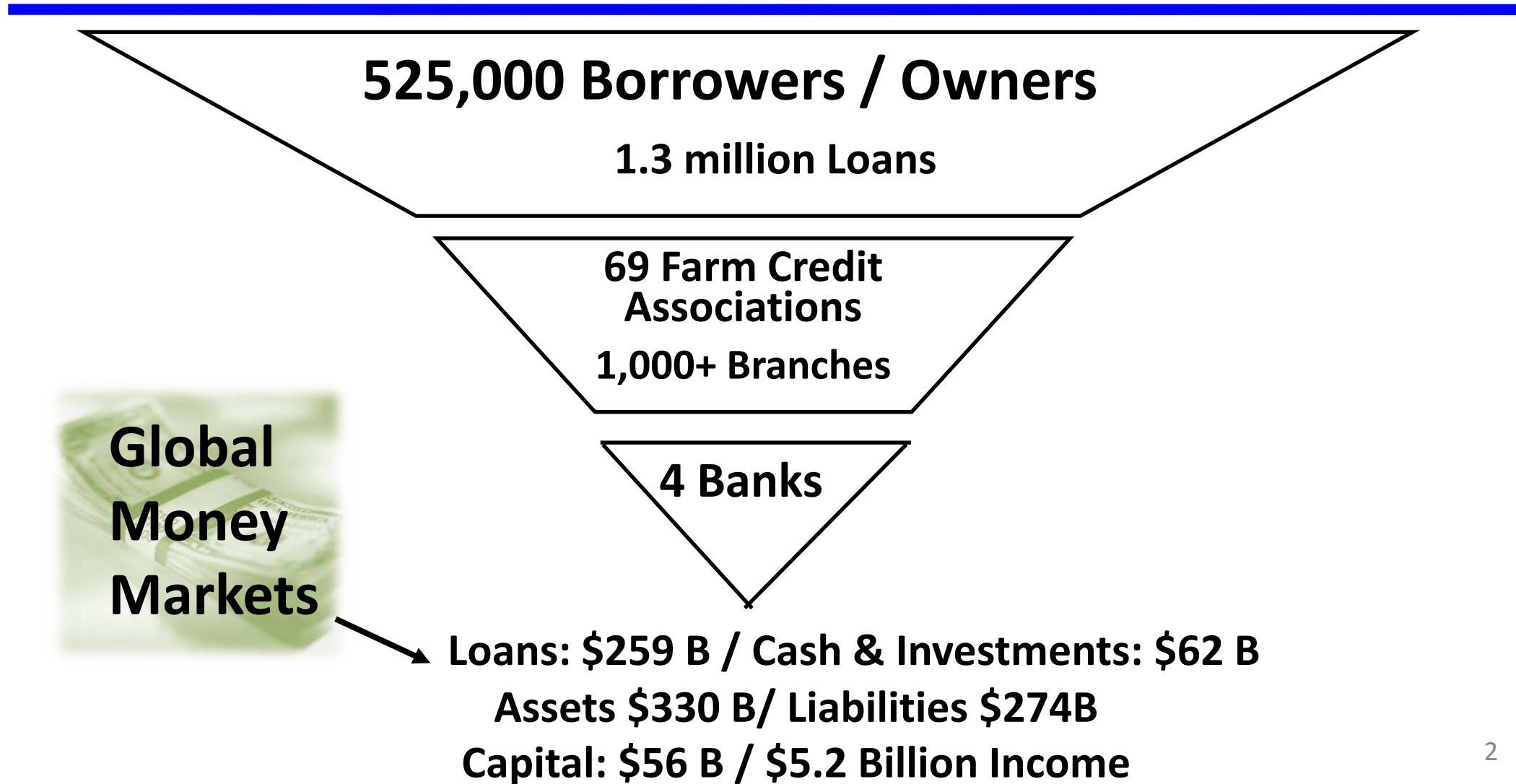
# Credit's Role in Risk Management Farm Credit System

**Commodity Futures Trading Commission  
Agricultural Advisory Committee Meeting  
April 5, 2018**

**Mike Duffy, Credit Specialist Program Manager  
Steve Koenig, Senior Economist  
Farm Credit Administration**

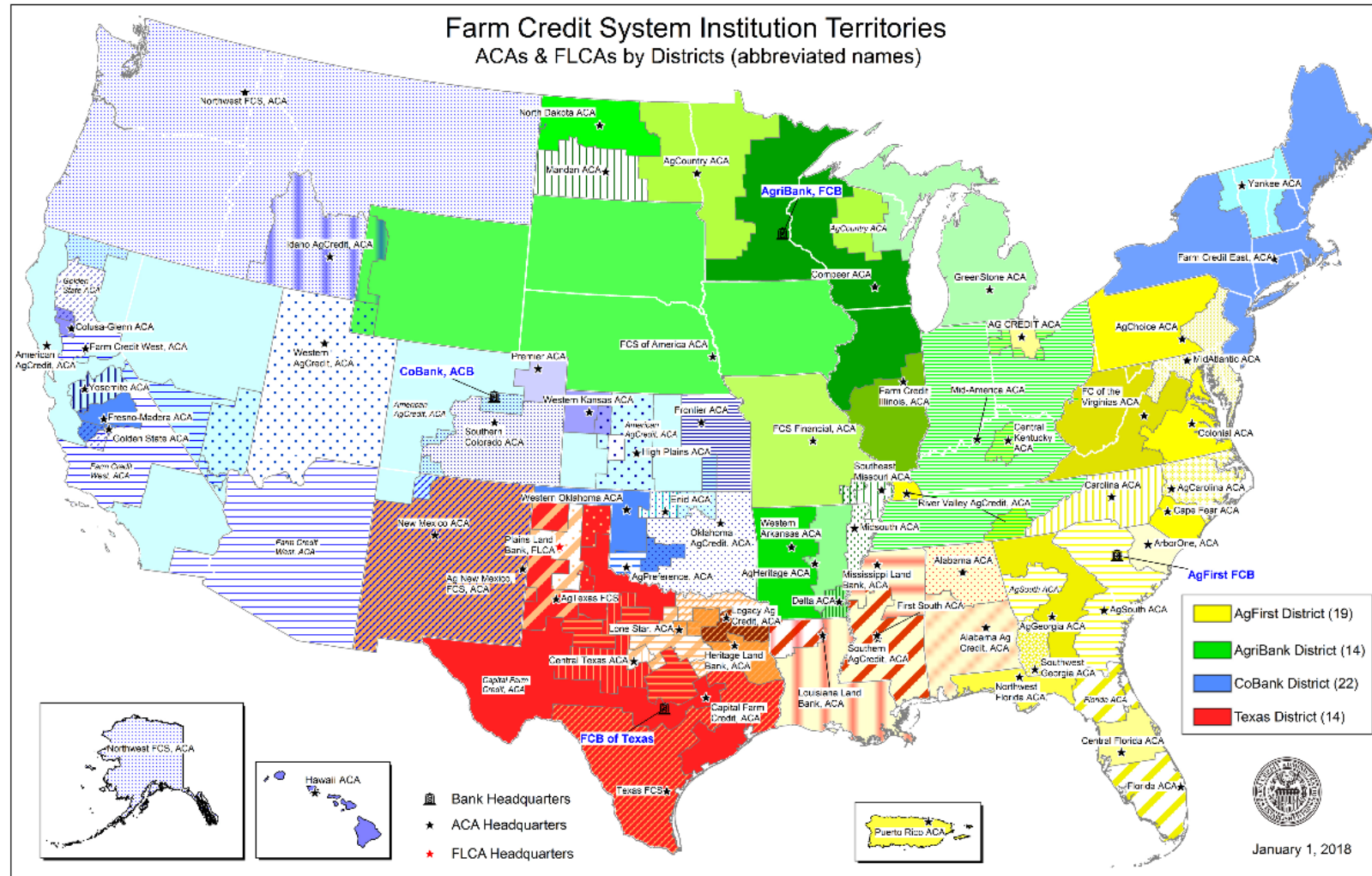


# The Cooperative Farm Credit System





# System Institutions

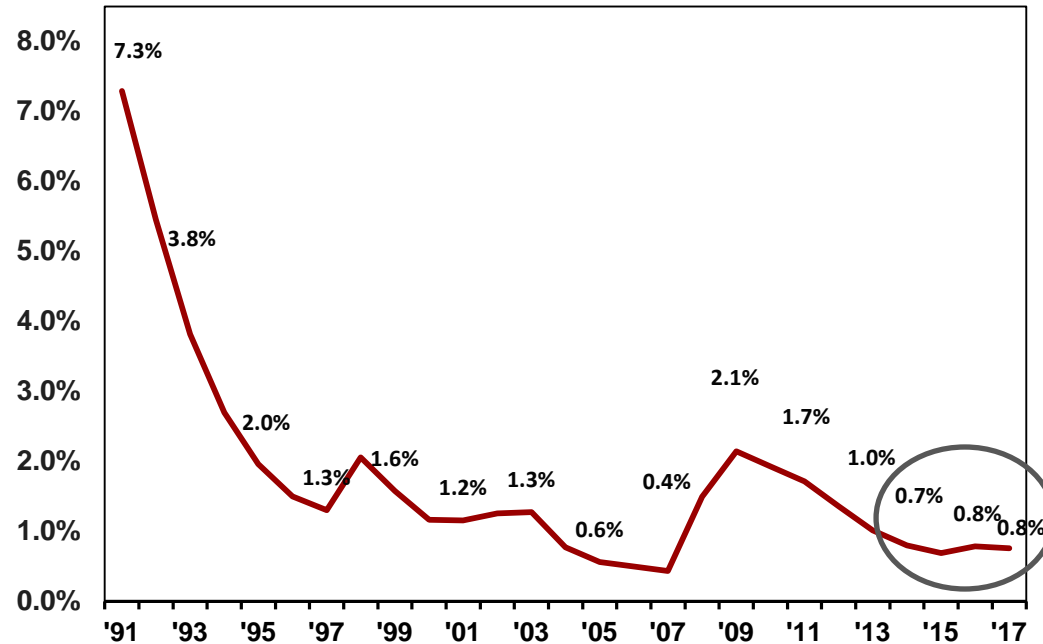




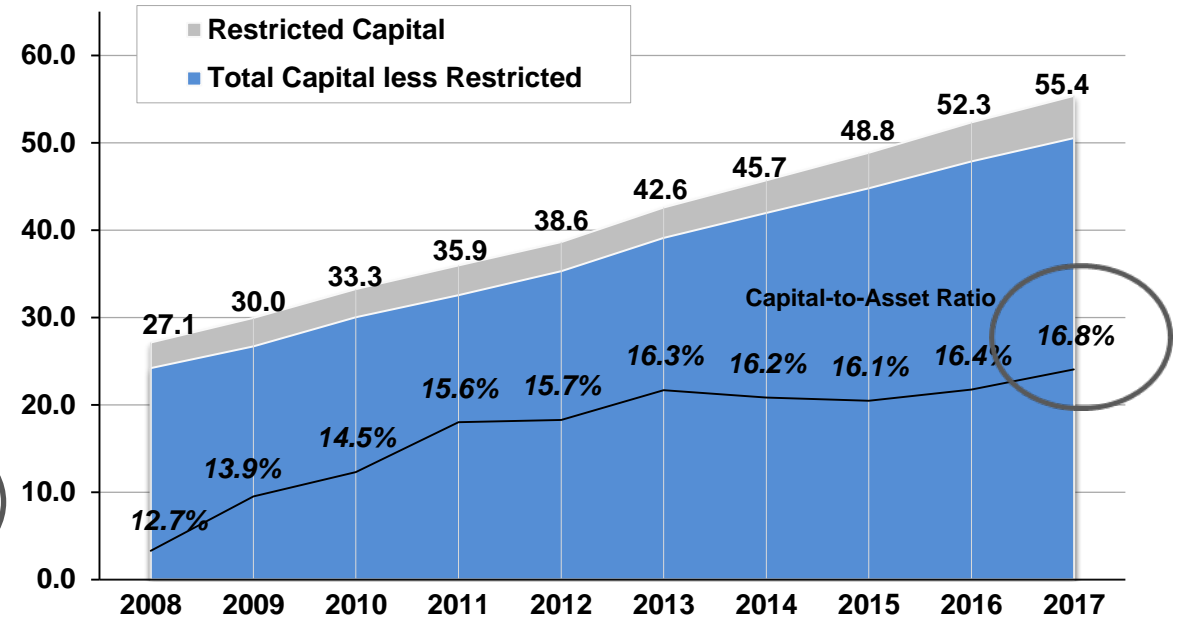
# System Financials are Strong



Nonperforming Loans as a % of Gross Loans



System Capital (\$B)

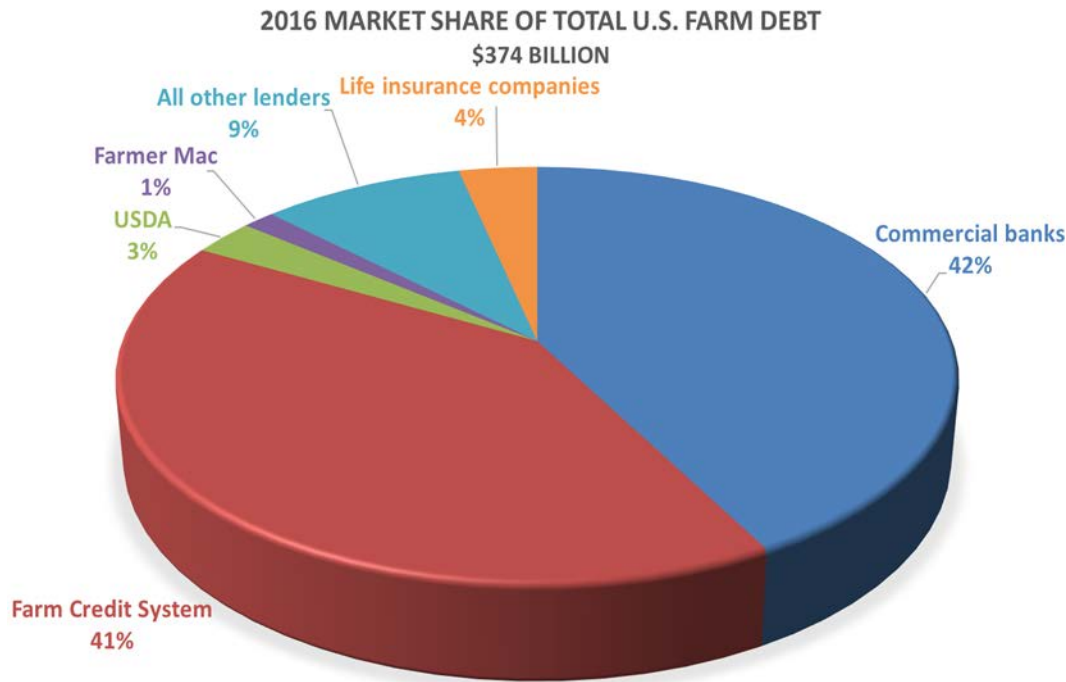


Restricted capital represents capital associated with the Insurance Fund.

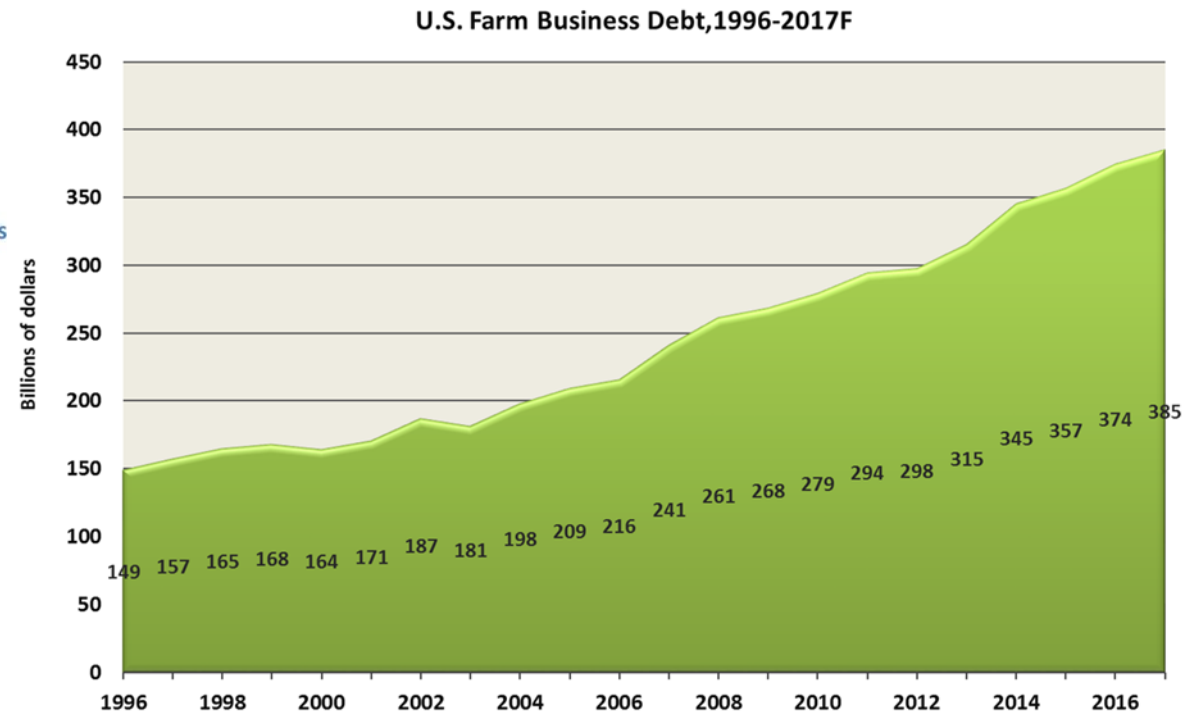
Source: FCS Annual Information Statements.



# Who Supplies Farm Debt?



Source: USDA/ERS.



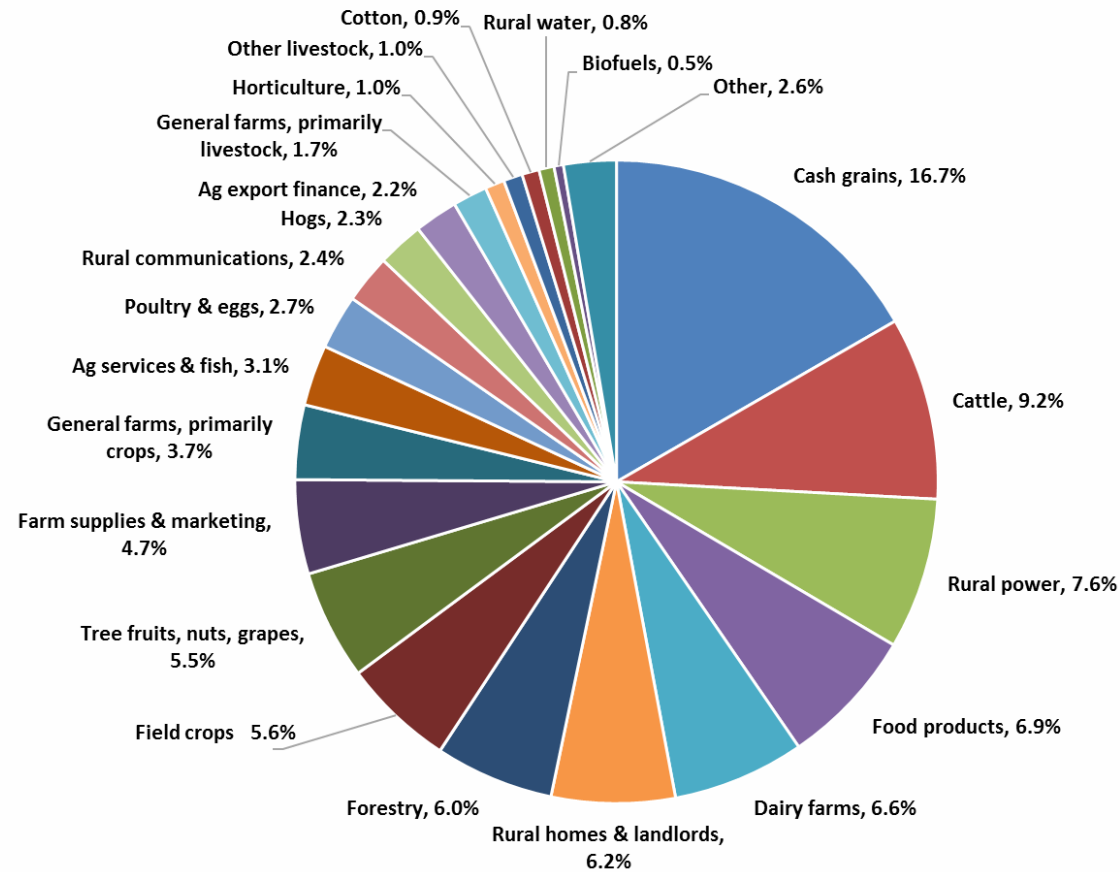
Year-end estimates shown. Source: USDA, Economic Research Service.



# FCS Loans by Commodity



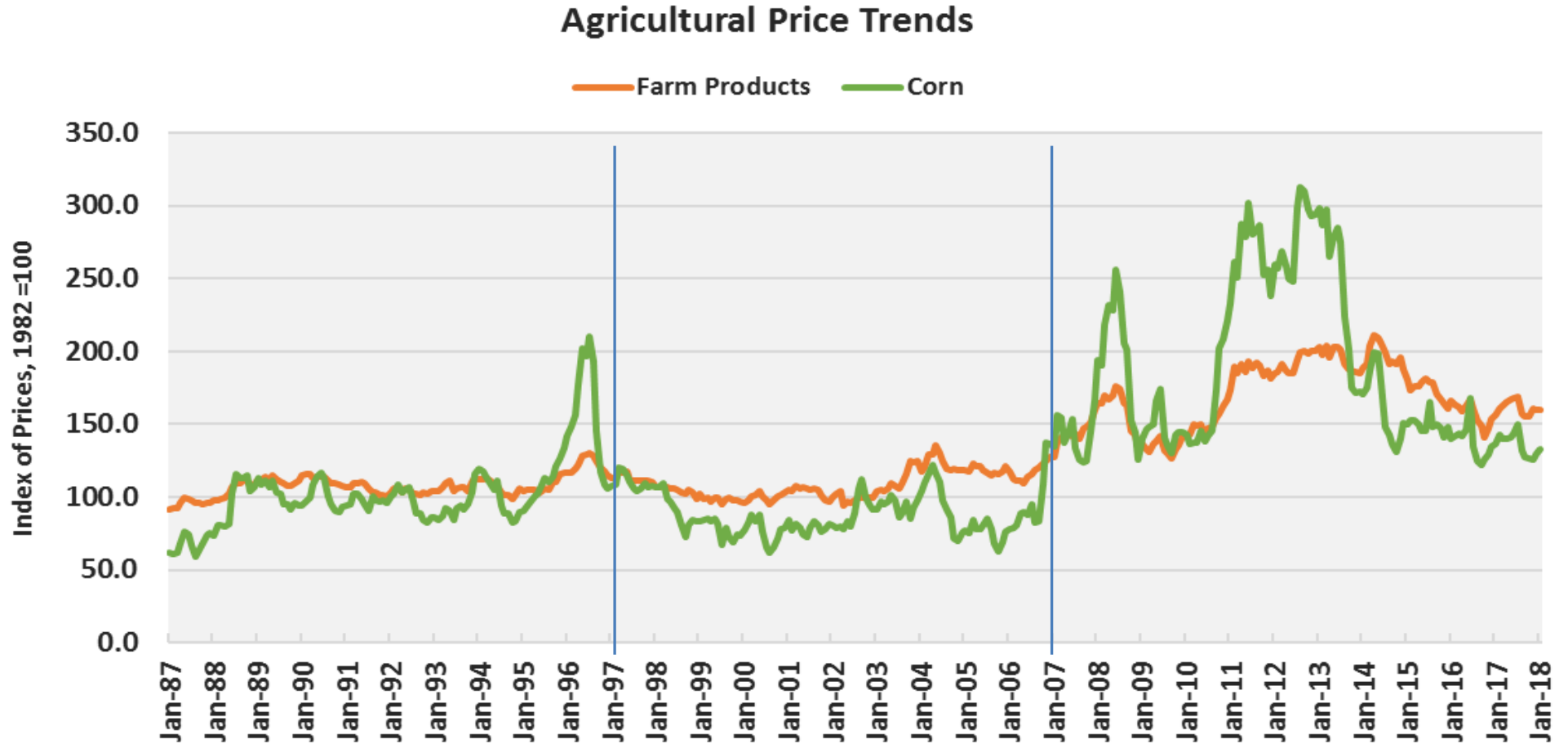
December 31, 2017  
\$259 Billion



Source: 2017 Annual Information Statement of the Farm Credit System.



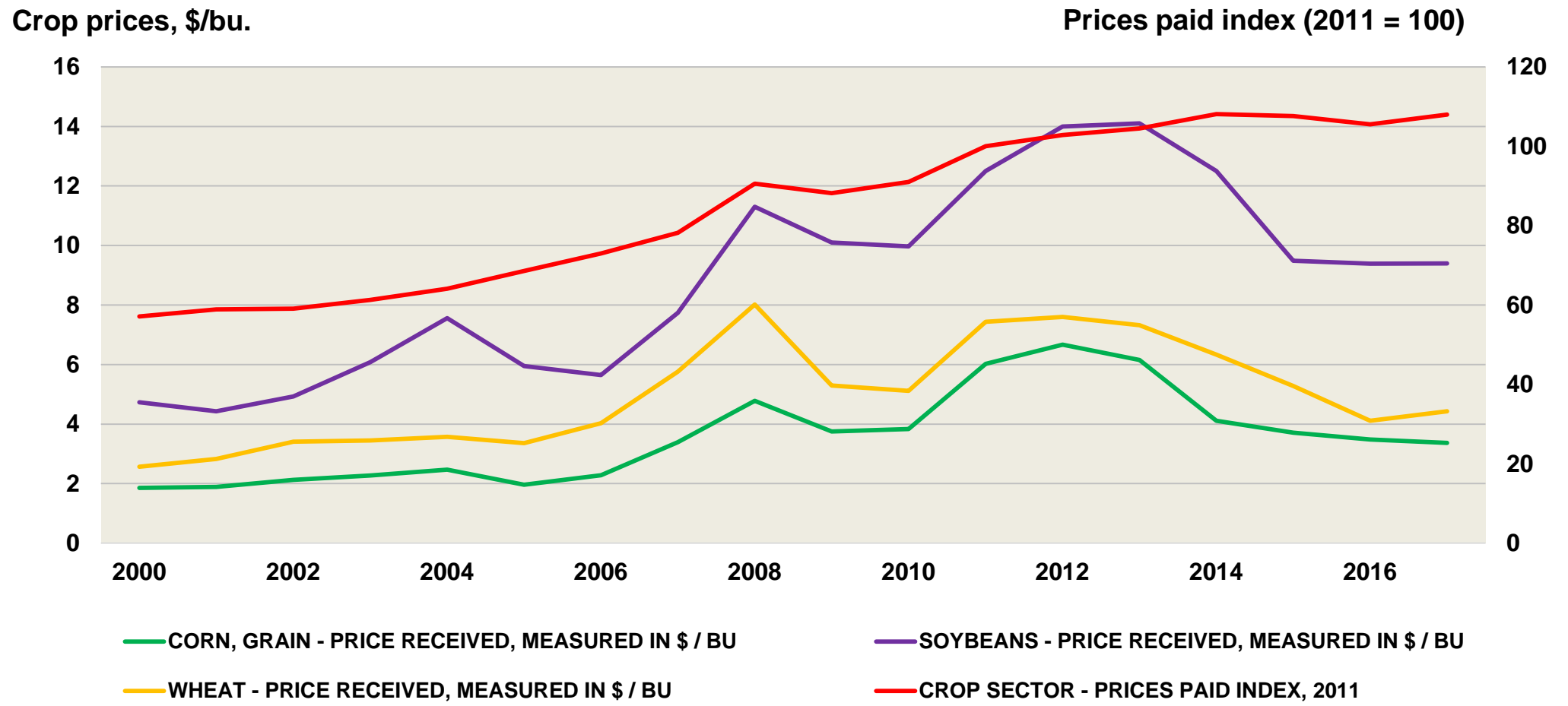
# Ag Price Trends Down; Volatility Up



Source: U.S. Bureau of Labor Statistics.



# Margins Squeeze: Crop Prices Adjust Faster than Input Prices



Source: USDA, NASS.





# Farm Business Income Down Again?

Farm businesses (farms with annual gross cash farm income of over \$350,000 or smaller operations where farming is reported as the operator's primary occupation) account for less than half of U.S. farms, but contribute over 90 percent of the farm sector's value of production and hold the majority of its assets and debt.

Farm Business Average Net Cash Farm Income

Commodity specialization	2016	2017F	2018F
		\$1,000	
<b>All Farm Businesses</b>	<b>102.8</b>	<b>100.5</b>	<b>93.2</b>
<b>Crops</b>			
Wheat	54.3	40.9	32.0
Corn	163.0	142.1	131.5
Soybeans	130.1	115.9	108.6
Cotton	337.8	485.8	441.4
Specialty crops	298.3	255.0	235.2
Other crops	84.7	77.6	72.4
<b>Livestock</b>			
Cattle and calves	32.7	34.0	36.1
Hogs	216.4	272.0	256.5
Poultry	110.5	112.6	106.8
Dairy	197.9	266.9	215.6
Other livestock	20.6	19.9	20.0

Source: USDA/ERS.



# Observations on Borrowers' Financial Positions

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- **Farm balance sheets hold up with resilient farmland prices**
- **Restructuring/Rebalancing is up**
- **Working capital declining**
- **Use of credit rising**
- **Interest rates rising**
- **Production cost adjustments continue**
- **Farm safety net helps**





# Financing Risk Management Activities

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- **Lenders providing funding for reasonable risk management is sound business**
- **Volatility and short profit windows create need for better risk management**
- **No cash outlays for basic tools (forward price, basis, hedge-to-arrive contracts)**
- **More sophisticated activities require financing**





# Financing Risk Management Activities

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- **Lender needs to understand risk management strategy to finance it**
- **Must be primary operating lender**
- **Exceptions exist but ideal scenario is:**
  - ❖ **Customer knows cost of production and has a written and executable marketing/risk management plan**





# Financing Risk Management Activities

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- **When a lender receives a request to finance risk management needs to decide:**
  - ❖ **Will funding be provided within core operating loan or stand-alone hedge loan**
  - ❖ **What will be the dollar amount of financing provided**





# Financing Risk Management Activities

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- **If stand-alone hedge loan, three way brokerage agreements now common (post MF Global)**
- **Reporting on hedging activity:**
  - ❖ **Expectations defined in covenants**
  - ❖ **Align with sophistication of risk management strategies**
  - ❖ **Monthly, quarterly, or “real time” brokerage position reports**





# Financing Risk Management Activities

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- **Red flags to lender in brokerage reports:**
  - ❖ **Three way option trades**
  - ❖ **Frequent placement and lifting of positions**
  - ❖ **Activity that differs from historical norms or size and scope of operation**





# Financing Risk Management Activities

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- **Lenders committed to financing risk management and valid hedging but not speculation**
- **Not always bright lines between hedging, margin management, margin enhancement and speculation**
- **Transparency and communication between borrower and lender is critical**







# Strengths, Challenges, Opportunities

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- **Some livestock producers are active “margin managers”**
- **Producer reluctance to go beyond cash sales and forward contracts, more education needed**
- **Lenders must understand impact of hedging on financial statements and covenants**





# Strengths, Challenges, Opportunities

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- **For effective risk management, must know cost of production, which requires high-quality financial records**
- **Risk management imperative for stressed producers**
  - ❖ **But need to focus on less cash intense strategies such as options and contracts with buyers**
- **Contracts that may not require delivery create challenges**





# Strengths, Challenges, Opportunities

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- **Lenders and borrowers need to stay committed to using and funding risk management strategies**
  - ❖ **Hog price spike in 2014**
  - ❖ **Grain price run-up in 2008**





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# Questions?



# Thank You!

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