

Chapter 3

Additional LGM Policy Provisions

In this chapter, you will learn:

- specific perils protected by LGM insurance;
- livestock ownership and record keeping requirements of LGM;
- how LGM provides flexibility and guaranteed premium pricing to producers;
- how to transfer coverage or assign an indemnity; and
- how LGM can reduce basis margin risk.

3.1 Introduction

Chapter 2 discussed the basic mechanics of LGM, including a description of terminology associated with the policy and step-by-step directions for finding Expected and Actual Gross Margins, Gross Margin Guarantees, and premium rates. The previous chapter also provided an in-depth example, which led to a discussion regarding how indemnities are determined and collected. This chapter focuses on the rules and policy provisions of LGM and addresses how these regulations affect producers.

3.2 Margin Protection Only

Recall from *Chapter 1* that LGM provides protection against a decline in the cattle feeding and swine finishing margin by simultaneously hedging the input costs of corn and feeder cattle and the fed cattle selling price (LGM for Cattle) or the input costs of corn and soybean meal and the swine selling price (LGM for Swine) as a sort of bundled option. LGM insurance pays an indemnity if the actual gross margin (AGM) established through a series of calculations by RMA (explained in *Section 2.4*) falls below the insured gross margin selected by the producer for the insurance period. LGM for Cattle is margin insurance that provides protection against decreasing feed margins caused by live cattle price declines and/or feeder cattle price and corn price increases, while LGM for Swine provides protection against the decreasing finishing margins caused by lean hog prices dropping and/or soybean meal and corn prices rising. No other type of loss is covered by LGM, including mortality, condemnation, physical damage, changes in local basis, or poor animal performance. For example, if livestock do not gain or perform as well as the producer expected when insuring the livestock, the lower production is not insured. For example, assume a cattle feeder plans to sell 1,250 pound steers (the standardized LGM finished

weight for a yearling finishing operation) when purchasing LGM coverage, but the steers only weigh 1,150 pounds when marketed. The *total* value of the lower production (weight) is not insured; however, any indemnity paid (the difference between the GMG and the AGM) will be calculated based on the originally insured 1,250 pound steers. The 100 pound difference in the insured weight (1,250 pounds) and the actual weight (1,150 pounds) is not covered through LGM insurance.

Any death loss of insured livestock that occurs does not need to be reported to the insurance agent (this is different than LRP where death loss must be reported within 72 hours). If total actual marketings (livestock that are insured under LGM and actually sold) are less than 75 percent of total target marketings (number of slaughter-ready livestock that are expected to be marketed in an insurance period and that are insured with LGM) for the 11-month (cattle) or 6-month (swine) insurance period, a producer's indemnity will be reduced by the percent that the total actual marketings for the insurance period fall below the total target marketings for the period (the premium will not be reduced). For example, if 500 head of cattle are to be marketed during the 11-month insurance period, but the producer reports only sale receipts for 350 head due to a large death loss, only 70 percent of the slated target marketings were sold. This in turn reduces the producer's indemnity by 30 percent. This adjustment to the indemnity is for the entire 11-month insurance period, not individual target marketing months. On the other hand, as long as the producer markets at least 75 percent of the marketings during the insurance period (even though some death loss does occur), the insurance coverage remains unchanged and indemnities are not reduced. Returning to the previous example with 500 head being marketed, if the producer sold only 400 head due to death loss (80 percent of target marketings), the insurance coverage and any indemnity payments are still determined as though the producer marketed 500 head in the target marketing months that he/she originally assigned cattle. So, adjustments are made only if producers market less than 75 percent of the total head during the insurance period. Note, however, that LGM does not insure the total value of animals that die, but it is possible to collect an indemnity on those animals if there was one due as a result of the total AGM being less than the GMG.

Another issue to consider regarding livestock ownership is the cash sale date of the cattle or swine. It may be difficult for a cattle feeder or swine finisher to time the selling of the insured livestock within the specified target

marketing month. This may be due to production issues, such as the livestock gaining weight faster or slower than expected. However, as long as the cattle feeder or swine finisher markets at least 75 percent of the proposed target marketings during the 11-month or 6-month insurance period, respectively, the insurance coverage remains unchanged and indemnities are not reduced. Basically, it does not matter if the actual marketing date of livestock differs by a month (or more) from the target marketing month(s) specified in the LGM insurance policy as long as producers market at least 75 percent of the proposed target marketings in the insurance period. Although indemnity calculations are unaffected and made according to the planned target marketing month, producers may experience a fluctuating price spread (between the AGM and cash gross margin) depending upon the sale date of the livestock. If cattle or swine are not sold in the specified target marketing month, cash gross margins in the previous or latter months may be higher or lower than the cash gross margin of the target marketing month. This would lead to varying price spreads that are not insured depending upon when the livestock were actually marketed. This is less of an issue in swine because standardized feeding has allowed for better market and slaughter timing (see *Section 1.3*).

The LGM policy does not prohibit a policy holder from obtaining separate insurance coverage for any other peril such as lightning, drowning, or full mortality. However, in order to protect against any of these losses, cattle feeders and swine finishers must obtain a separate property and casualty insurance policy because these are not losses insured by LGM.

3.3 Livestock Records

As *Section 1.5* discussed, the producer purchasing LGM coverage must have substantial beneficial interest (SBI) in the insured livestock. An example of this form can be seen in *Appendix 1*. Producers must also keep accurate records regarding livestock insured with LGM. Certified by the producer, target marketings are subject to inspection by the insurance agent in order to verify the marketings. All records relating to the feeding, finishing, and sale of the cattle, or the breeding, farrowing, feeding, finishing, and sale of the swine, as well as an examination of the livestock themselves, are subject to inspection. Producers must retain all records for three years after the 11-month insurance period for cattle or 6-month insurance period for swine has ended. These records include, but are not limited to, purchase, feeding, shipment, sale, or other documents of transfers of all livestock insured and not insured. RMA may also request records relating to the insured livestock from anyone who may have custody of the records, including packers, financial institutions, shippers, sale barns, terminals, cooperatives,

associations, or accountants. It is the producer's responsibility to assist in obtaining all records from third parties requested by RMA.

3.4 Guaranteed Pricing

One important distinction between LGM insurance and futures and options contracts is the process by which prices, and essentially indemnities, are determined. Futures and options prices are negotiated in the market; whereas, LGM prices are established according to pricing and basis regulations established by RMA (see *Section 2.4*). The prices associated with LGM are still based on the futures and options markets though. Generally speaking, the options market has a relatively low volume of trades, particularly for deferred months (those contracts several months in the future). This implies that when buying an option, it is unlikely that a cattle feeder or swine finisher will necessarily be able to buy at the price most recently traded, but rather may have to "move the market" to fill his/her order between the last traded/quoted price and the new fill price. The reason for this difference is that a bid/ask spread exists in the options market (as well as the futures market) because prices are negotiated by buyers and sellers. The bid/ask spread refers to the difference between the bid price (how much buyers are offering to pay) and the asking price (how much sellers want in order to sell). Because the options market may be lightly traded, buying an option may require the buyer to bid higher than the current market price to get the order filled and buy the contract. For example, if a given put option is trading at a cost of \$0.90/cwt, a potential buyer may have to bid at \$0.95/cwt to find a willing seller; the buyer has to bid the price higher to buy the options contract depending on market conditions. This means someone wanting to hedge with options contracts might not know exactly how much the price coverage will cost until after the purchase is made (when using a market order).

LGM insurance premiums are established by RMA on the sales closing date of each month. Once set, the expected gross margins for specific target marketing months and premiums are guaranteed and will not change. This allows feeders and finishers to know precisely what price level will be insured and how much the coverage will cost.

3.5 Coverage Transfer and Indemnity Assignment

At times it may be advantageous to be able to grant the right to receive an LGM indemnity payment to another person or entity, like a lender. LGM provides two alternatives for doing so. One method involves transferring ownership of the insured livestock and LGM insur-

ance policy, while the second involves assigning only the indemnity payment — ownership of the livestock does not change. With the first type, if an insured party transfers ownership of any portion of the covered livestock, the insurance coverage for that portion of the livestock can be transferred as well, so long as the new owner is eligible for LGM insurance. To transfer coverage, a Transfer of Right to Indemnity Form must be filed with the current owner's insurance agent and approved by the company before the transfer takes effect. An example of this form is in *Appendix 4*. A logical question might be whether the livestock being sold are worth more because they are insured. The answer depends on the insured gross margin, current market conditions, and the amount of time left until the end of the insurance period. If the insured gross margin is substantially higher than the current gross margin and the expiration date is near, the seller may be able to have part of the insurance's expected indemnity bid into a higher price. However, if the current gross margin is higher than the insured gross margin, there may be little added value in the insurance on the livestock.

Assigning the right to collect the indemnity does not involve a change in ownership of the insured livestock and policy. Instead, the owner transfers the right to collect an indemnity payment from the insurance coverage. The insured owner files an Assignment of Indemnity Form with the insurance company, and, once approved, the party assigned the right to the indemnity (the assignee) has all rights to claim any indemnity that may be due. If any indemnity is due, the actual owner of the livestock can still file a marketings report within 15 days of receiving a notice of probable loss. If the actual owner fails to do so, the assignee may submit the marketing report no later than 15 days after the initial 15-day period has expired. Assigning an indemnity payment to another party may be useful if the second party has a collateral interest in the cattle or swine, such as a lender that provided financing. See *Appendix 5* for an example of an Assignment of Indemnity Form. Filing a claim for an indemnity was discussed in *Section 2.6*. In order for the assignee to collect the indemnity, the livestock owner (who holds the policy) must not violate any policy provisions that might void the coverage as discussed in the next section.

3.6 Hedging Considerations with LGM

One aspect of LGM that differentiates it from futures or options hedging is LGM's status as an insurance product. Unlike futures or options contracts, LGM is technically not considered a derivative product even though the coverage is similar to that available in the derivatives market (i.e., options market). LGM is reinsured by the Federal Crop Insurance Corporation (FCIC), and

although no producer premium subsidy is available for this insurance program like that offered through crop insurance programs, all administrative and policy expenses incurred by the crop insurance companies are paid by the federal government rather than insured producers. Therefore, cattle feeders and swine finishers purchase LGM without commission or administrative fees; with futures or options hedging, each trade has an associated commission fee.

Insuring cattle or swine with both Livestock Risk Protection (LRP) Insurance and LGM is prohibited. A producer can, however, insure livestock with LRP, and once the policy is lifted, insure the same livestock with LGM. For example, a producer may choose to back-ground 550 pound calves on pasture before placing them into the feedlot. In this instance, the 550 pound calves could be insured with LRP. Once the LRP policy is lifted (assume calves are now 750 pounds and in the feedlot), the producer could insure the same cattle with LGM. Interestingly, producers can use offsetting transactions in the futures and options markets to effectively lift an LGM hedge. This can be accomplished by reversing the protection provided by LGM for Cattle through the use of short feeder cattle and corn calls and short fed cattle puts. Using short soybean meal and corn calls and short lean hog puts would reverse the protection LGM for Swine offers. It is important to note that the insured party cannot sell the LGM coverage back to the insurance company to recover any premiums. This restriction means that LGM coverage cannot be lifted using the latter method. Once the coverage is purchased, it will remain in place until the end of the insurance period and the coverage expires. (The policy will continue in force for each succeeding 11-month or 6-month insurance period purchased unless canceled or terminated by way of written notice on or before the cancellation date from either the insurance agent or the insured.) This means the only date the coverage has value is on the end date when an indemnity is determined. A lender or other party with collateral interest in the insured livestock may view this restriction favorably. However, some producers may prefer the flexibility provided by futures or options contracts, because they can be bought or sold any time the markets are trading. If the hedged livestock are sold earlier than expected, the futures or options hedge can be lifted at that time. Also, a futures hedge can be lifted early if markets have moved such that a profit on the hedging instrument can be captured. For example, if a producer is short live cattle at \$96.00/cwt, and the market drops to \$90.00/cwt, the producer can capture the \$6.00/cwt profit in the futures market and then speculate on the cash price from there.

While LGM is based on futures market prices and provides protection similar to a bundled option on futures contracts, producers using LGM take no futures

or option positions themselves and therefore do not need a brokerage account. Because it is different from traditional options or futures, LGM offers several advantages. By allowing producers to sign up 12 times per year and insure all of the cattle they expect to market over an 11-month period or all swine they expect to market over a 6-month period, insured producers do not need to choose the mix of options to purchase, the strike prices of the options, or the date of entry into various option contracts. They can also purchase multiple policies and thereby insure just certain months of target marketings for additional flexibility. LGM can be customized to fit the needs of any size operation (within policy limitations). Futures and options cover fixed amounts of commodities. For example, one feeder cattle contract covers 50,000 pounds, one fed cattle or swine contract is 40,000 pounds, one corn contract represents 5,000 bushels, and one soybean meal contract equals 100 tons. Often, these amounts are too large to be used effectively in the risk management portfolios of smaller operations. As stated in *Section 1.7*, the difficulty in using options on futures is compounded by the ratio producers would need to equalize live cattle, feeder cattle, and corn contracts for a cattle operation and lean hog, soybean meal, and corn contracts for a swine operation according to production practices so as to not over or under hedge one or more of the commodities. Because each fed cattle, feeder cattle, and corn contract represents approximately 32, 67, and 87 head of cattle respectively (and each lean hog, soybean meal, and corn contract is equal to approximately 216, 1,020, and 361 head of swine respectively), finding the least common denominator of head in order to have an even number of futures contracts will result in a large number of futures contracts. For most producers, especially those with smaller operations, this is not practical. The LGM policy basically combines the three commodities in an equivalent fashion for producers, so they do not have to purchase multiple contracts to be hedged in each commodity. Because there is no minimum number of head to insure with LGM, producers with smaller-sized operations can use LGM without hedging more livestock than they plan to sell.

3.7 Basis Margin Risk Coverage

When hedging with futures or options contracts, the difference between the local cash price and the futures market price must be considered when calculating an expected price. This difference between the cash and futures price is called basis. When using LGM to hedge cattle or swine prices, basis must still be considered; however, with LGM, futures basis used in traditional hedging is irrelevant. While LGM margins are based on futures prices, state- and month-specific historical LGM basis adjustments are made to the LGM adjusted futures prices. So, producers using LGM are hedging with an instrument based on cash market prices, not futures prices. The appropriate LGM basis margin, then, is based on the historical difference between the adjusted futures price (including the policy's fixed historical LGM basis) and the local cash price producers actually receive (using current local prices). Although some basis margin risk is reduced by insuring with LGM, the risk of changes between actual basis levels and the fixed basis in LGM adjusted futures prices leave producers still partially exposed to cash margin price risk. The prices used to calculate the expected and actual gross margins are not the same as the cash prices cattle feeders realize in their own local fed cattle, feeder cattle, and corn markets or the cash prices swine finishers realize in their local swine, soybean meal, and corn markets. LGM basis margin risk will be explained in detail in *Chapter 4*.

3.8 Summary

This chapter discussed several policy provisions and underwriting rules that are important in understanding LGM insurance. LGM provides price protection by insuring the cattle feeding or swine finishing gross margin. LGM offers guaranteed premium pricing and provides more flexibility than options or futures in terms of the number of cattle or swine covered. LGM coverage and indemnities can be transferred or assigned to another party. Finally, LGM provides a potential reduction in basis margin risk. All of these factors must be carefully considered by producers when determining if LGM is right for their hedging needs. *Chapter 4* will provide a more in-depth look at LGM basis as well as an analysis of optimal insurance periods and target marketing months in which to purchase LGM coverage.