

## Chapter 2

### *Additional Policy Provisions—LRP Advantages and Disadvantages*

#### **In this chapter, you will learn:**

- specific perils protected by LRP insurance;
- livestock ownership requirements of LRP;
- how LRP provides flexibility and guaranteed premium pricing to users;
- how to transfer coverage or assign an indemnity;
- why offsetting transactions and lifting hedges are not allowed when using LRP; and
- how LRP can reduce basis risk.

#### **2.1 Introduction**

Livestock Risk Protection (LRP) insurance is a relatively simple program in comparison to some hedging strategies, and Chapter 1 provided a basic description of how the program insures livestock selling prices for producers. Basic program provisions such as the states where LRP is available, which livestock qualify, how to enroll in the program, how to purchase coverage, and annual insurable limits were covered in the opening chapter. Also, the first chapter discussed how LRP can be used as a risk management tool. A producer may wonder, “If LRP operates like a put option (as described in Section 1.1), is it better to use one than the other?” Chapter 2 focuses on some rules and policy provisions of LRP and addresses how some rules may be advantageous or disadvantageous to producers.

#### **2.2 Single-Peril Coverage**

Recall from Chapter 1 that LRP provides price protection for insured livestock by establishing a floor price for the insured livestock. The insurance pays an indemnity if a national cash price index falls below the insured price level at the end of the coverage period. LRP is single-peril insurance in that it only provides protection against price declines. No other type of loss is covered by LRP, including mortality, condemnation, physical damage, disease, individual marketing decisions, local price aberrations (basis changes), or poor animal performance. For example, if livestock do not gain as well as the producer had expected, the lost production is not insured. Assume a cattle feeder plans to sell 1,300 pound steers when enrolling in LRP but the steers only weigh 1,200 pounds when sold. The *total* value of lost production (insured price level multiplied by 100 pounds) is not insured; however, any indemnity paid (the difference between Coverage Price and the national cash index at the end of cover-

age) will be calculated based on the originally insured 1,300 pound steers (the amount originally insured and listed on the Specific Coverage Endorsement or SCE). Also, because mortality is not insured, the value of any livestock that die is not indemnified by the LRP policy. If a hog producer has 500 head of market hogs insured with LRP and 10 die, the *total* value of the dead hogs is not insured (insured price multiplied by the number of dead hogs). However, if the owner reports the death of the insured hogs to the LRP insurance agent within 72 hours, these dead hogs are still eligible for an indemnity if one would be paid based on market conditions (the indemnity would be paid for the total number of head insured). Some producers might consider factoring in death loss when purchasing coverage. Assume Joe Farmer has 100 hogs to insure and knows he generally has a 2 percent death loss; he might decide to purchase coverage for only 98 head.

The potential problem with factoring in death loss when purchasing coverage like this is that the policy holder must keep close track of how many animals died. If Joe has more than two hogs die, he needs to report the additional deaths to prevent voiding coverage on the dead animals. If Joe forgets to report additional deaths, the amount insured on the SCE will be reduced by the number of deceased head with no refund of premiums. However, if he insured all 100 head and reported any deaths that occur, he does not have to worry about which hogs need to be reported and which do not. By reporting all mortality, Joe has established a good habit to consistently report the death of covered animals, and he does not have to count how many hogs die before he must start reporting.

The LRP policy does not prevent a policy holder from obtaining separate coverage for any other peril such as lightning, drowning, or full mortality. In order to protect against any of these losses, producers must obtain a separate property and casualty insurance policy.

#### **2.3 Livestock Ownership**

As Section 1.5 discussed, an applicant for LRP insurance must have Substantial Beneficial Interest (SBI) in the insured livestock. The insurance company, any person designated by the company, or any person designated by a USDA agency may request proof of ownership of insured livestock at any time up to three years after the end of coverage. Ownership can be

verified by the purchase receipts from prior owners, financing documents from a lender that financed the livestock purchase, or a bill of sale when the insured livestock are sold. Alternatively, third-party statements may be used to verify ownership. For example, if a veterinarian or feed supplier is familiar with the operation, has visually inspected the insured livestock, and can attest to the insured's ownership, that veterinarian or feed supplier can provide a written statement stating the time and number of livestock owned by the producer.

Another issue to consider when discussing ownership is the cash sale date of the livestock. The LRP coverage has a specific ending date (see Sections 1.8 and 3.2) when the indemnity is determined. The insured party must maintain ownership until at least 30 days prior to that ending date. If the livestock are sold more than 30 days before the end date, the insurance coverage is void and premiums are not refunded.

It may be difficult for a producer to time selling the covered livestock with the expiration of the insurance. There may be production issues, such as the livestock gaining weight faster or slower than expected. This may be more of an issue for feeder cattle and fed cattle than for swine. However, livestock can be sold any time after 30 days before the end date or any time after the end date without voiding coverage. By allowing this marketing window of 30 days prior to the end date designated on the SCE, producers are provided some flexibility to address individual marketing and/or production needs. Although it may be favorable or even necessary to sell livestock prior to the LRP coverage end date (but still in the allowed 30-day window), doing so creates some price risk (Figure 2.1). If prices are below coverage levels at the time of the cash sale, the producer will receive a lower cash price. Then, if prices rise between the cash sale and the ending date of coverage, the producer will not receive as large an indemnity or may receive no indemnity at all. Essentially, the producer is losing the price protection provided through paying the premium.

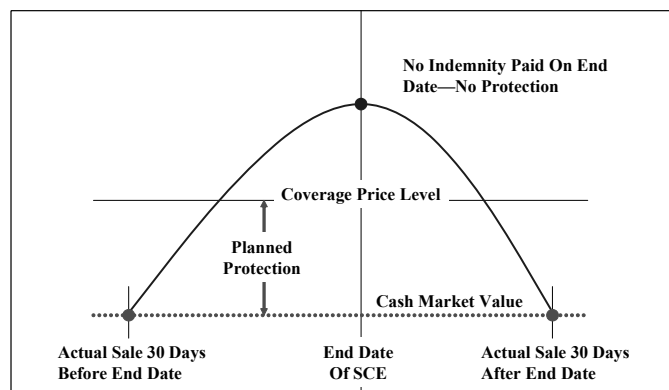


Figure 2.1

One factor to consider when determining when to sell livestock is the potential for future price movement. In other words, if a producer delays selling cattle (particularly after the end of coverage is reached), what is the chance prices will go up or down? To assess this situation, consider the change in price relative to some point in time before that point. Table 2.1 below shows the average 30-day change in price for swine, fed cattle, and feeder cattle as well as the largest increase and decrease for each.

Table 2.1 30-Day Price Change (2001-2004).

	Average (\$/cwt)	Largest Decrease (\$/cwt)	Largest Increase (\$/cwt)
Swine (CME Index)	-0.19	19.10	12.64
Fed Cattle (5-Area Price)	0.22	25.56	18.57
Feeder Cattle (CME Index)	-0.05	15.26	6.72

The data indicate that, on average, there is little incentive to delay selling livestock for 30 days. Only fed cattle have a higher average price relative to 30 days before at \$0.22/cwt higher, while swine and feeder cattle had lower average prices relative to 30 days before. However, there is significant risk of large decreases, up to \$25.56/cwt for fed cattle, \$19.10/cwt for swine, and \$15.26/cwt for feeder cattle. There is also potential for large price increases as well, but in the long run the increases and decreases essentially average close to zero. This means there would be a big risk for what is, on average, a small return if trying to optimally time livestock sales dates and LRP end dates.

## 2.4 Guaranteed Pricing

One important distinction between LRP insurance and futures options contracts is how prices are determined for each. Futures and options prices are negotiated by the market whereas LRP premiums are set by RMA. Generally speaking, the options market has a relatively low volume of trades, particularly for deferred months (those contracts several months in the future). When buying a put option, it is unlikely that a producer 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. The reason for this difference is that a bid/ask spread exists in the options

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 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 \$1.00/cwt, a potential buyer may have to bid \$1.05/cwt to find someone willing to sell; the buyer has to bid the price higher to buy the options contract. 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).

LRP insurance premiums are established after the futures and options markets close for the day, and, once set, the prices and premiums are guaranteed for that day and will not change. This allows a producer to know precisely what price level will be covered and how much the coverage will cost. Also, because LRP is only available when futures and options markets are *not* trading (5:00 p.m. until 9:00 a.m. Central Time), it provides after-hours price protection. Having guaranteed prices and after-hours availability can benefit producers who are not able to closely monitor markets through the course of a day. They can analyze available prices and premiums and call their insurance agent in the evening (provided the agent is available for after-hours purchases) without the chance of markets moving or prices changing.

## 2.5 Coverage Transfer and Indemnity Assignment

At times it may be advantageous to be able to grant the right to receive an LRP indemnity payment to another person. LRP provides two alternatives for doing so. One method involves transferring ownership of the insured livestock and LRP insurance 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 also be transferred, so long as the new owner is eligible for LRP 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 3. A logical question might be whether the livestock being sold are worth more because they are insured. The answer depends on the insured price, current market conditions, and the amount of time left until coverage expires. If the

insured price is substantially higher than current prices 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 current prices are higher than the covered price, there may be little added value in the insurance on the cattle.

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 any indemnity payment from the insurance coverage. The insured owner files an Assignment of Indemnity Form with the insurance company, and, once approved, the assignee has all rights to claim any indemnity that may be due. In this case, if any indemnity is due, the party assigned the right to the indemnity (the assignee) must file the proper claim form, not the actual owner of the livestock. Assigning an indemnity payment to another party may be useful if the second party has a collateral interest in the livestock, such as a bank that provided financing. See Appendix 4 for an example of an Assignment of Indemnity Form. Filing a claim for an indemnity will be discussed in Section 3.7. 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 (e.g., selling the livestock 31 or more days prior to the expiration of coverage).

## 2.6 Insurance Policy as a Hedging Instrument

One aspect of LRP that differentiates it from futures or options hedging is LRP's status as an insurance product. Unlike futures or options contracts, LRP is technically not considered a derivative product even though the coverage is similar to that available in the derivatives market (i.e., futures market). USDA provides a subsidy to offset some of the program's costs. One subsidy pays 13 percent of the total premium cost. Also, the insurance companies selling LRP receive an additional subsidy that covers the administrative costs and fees. Therefore, producers purchase LRP without commission or administrative fees; with futures or options hedging, each trade has an associated commission fee.

While the subsidies reduce the financial burden of the program, they are not intended to be a direct payment, so some restrictions on LRP exist. Any person who purchases LRP coverage may not take an offsetting position in the futures or options market that would negate the benefit of LRP protection and recover the subsidy. For example, the LRP coverage holder may not write (sell) a put option or go long in the futures market. This rule is in place to prevent someone insured with LRP from converting the gov-

ernment subsidy into funds available for use by the insured or anyone affiliated with the insured. If someone with LRP coverage does take an offsetting futures or options position as described above, the coverage will be void and the premiums paid for the coverage will not be refunded. However, this rule does not prevent an insured party from trading the underlying futures or options contracts (e.g., selling futures contracts, buying put options, or selling call options).

It is important to note that the insured party cannot sell the LRP coverage back to the insurance company to recover any premiums. This restriction combined with the rule against offsetting futures or options transactions means that LRP coverage cannot be lifted. Once the coverage is purchased, it will remain in place until the expiration date is reached. Offsetting the hedge by taking an opposite position in the futures or options market is not permitted, and the policy cannot be sold back to the insurance company. Essentially this means the only date the coverage has value is on the end date when an indemnity is determined. A bank or other group with collateral interest in the insured 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.

## 2.7 Basis Risk Coverage

When hedging with futures or options contracts, the difference between a local cash price and the futures market price must be considered when calculating an expected selling price. This difference between cash and futures price is called basis. When using LRP to hedge livestock prices, basis must still be considered;

however, with LRP, futures basis used in traditional hedging is not relevant. The appropriate LRP basis is the difference between the cash price received and the cash price index against which the policy is indemnified. LRP basis risk relative to futures basis risk is generally smaller for Nebraska producers because Nebraska cash market prices are weighted relatively heavily into the cash price indexes. With Nebraska prices included in the indexes, they will more closely reflect prices actually received by Nebraska producers. As a result, basis risk can be substantially reduced when using LRP insurance. This is true primarily for fed cattle and swine but is less applicable to feeder cattle. Basis risk will be explained in detail in Chapter 4.

## 2.8 Summary

This chapter discussed several policy provisions and underwriting rules that are important in understanding LRP insurance. LRP provides single-peril price risk by insuring only the price level for covered livestock. Ownership verification may be requested at any time by the insurance company, and the insured livestock must be owned up to 30 days prior to the coverage expiration. As a subsidized insurance product, LRP imposes restrictions on offsetting futures or options transactions, and once purchased, the coverage provided by LRP cannot be lifted. Offsetting transactions (selling a put option or buying futures contracts) will void LRP coverage. LRP has guaranteed pricing and provides flexibility to users in terms of the number of livestock covered. LRP coverage and indemnities can be transferred or assigned to another party. Finally, LRP provides a reduction in basis risk. All these factors along with any advantages or disadvantages they give rise to must be considered by producers when determining if LRP is right for their hedging needs.