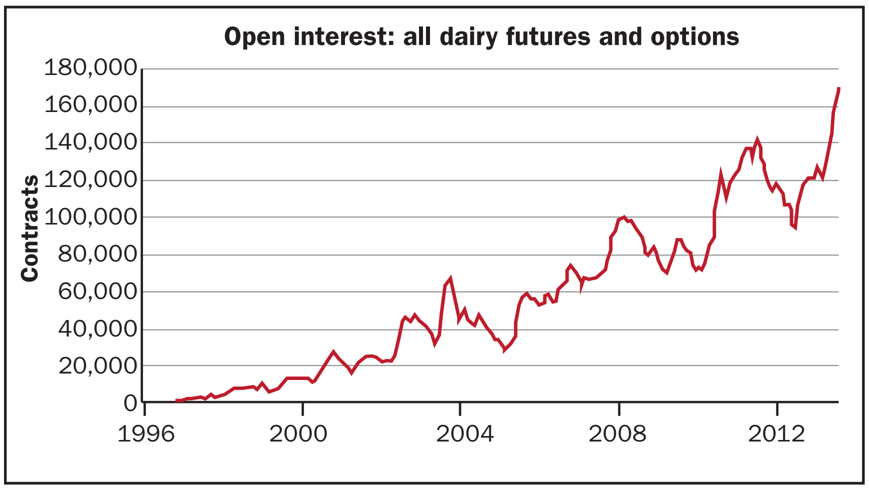
Will margin insurance crowd out futures activity?

by Mark Stephenson, Marin Bozic and Christopher Wolf



THE farm bill, more formally known to those in Congress as the Agricultural Act of 2014, included a new program for dairy producers to help manage milk and feed price risk. That specific program called the Margin Protection Plan (MPP) is an insurance product that will be managed by the Farm Service Agency (FSA).

Farms will be able to protect a national average measure of income over feed costs (IFOC) at $8 per hundredweight (cwt.) or below. The premium rates are fixed over the life of the bill and they appear to be well below an actuarially fair cost — that is to say, they are a good buy. This is especially true when you can select your protection each year with some knowledge of future market conditions.

What about other tools?

Some folks have wondered if producers will use this program heavily and, if so, whether such a program will negatively impact futures market activity. The most important role of futures markets is to transfer risk from hedgers to speculators.

A **hedger** is anyone who produces or buys the physical product being traded. A dairy farmer or a cheese plant may participate in the market to hedge their price for milk.

A **speculator**, on the other hand, does not produce or buy milk but is hoping to earn profit by correctly anticipating price movements. The speculator accepts the price risk that hedgers want to relieve themselves of. If the government is willing to accept producers' price risk, then dairy farms may have less incentive to sell futures contracts for milk or buy contracts for corn or soybean meal. This would be a kind of "crowding out" of private action that occurs when government activities compete.

Viability remains important

There are at least three reasons why we should care that dairy futures and options markets remain viable.

First, derivative markets perform a price discovery function. Dairy futures markets provide unbiased price forecasts which serve as valuable input in budgeting for producers and processors alike.

Second, continued growth of dairy exports requires that exporters be able to offer dairy buyers overseas fixed price contracts. Without CME markets to assist them in doing so, our export competitiveness may be jeopardized.

Finally, like the rest of the 2014 farm bill, MPP expires at the end of 2018, with uncertain chances of renewal. The industry would not want to jeopardize the viability of dairy derivative markets that took 20 years to develop.

We conducted a very short survey directed at people with some knowledge of both the Margin Protection Plan (MPP) and futures markets and asked them about the issue. Twenty-seven people representing producer and processor organizations, brokers, academics, government regulatory and others participated in our survey.

1. The first question asked how much volume on the Chicago Mercantile Exchange Class III contracts were represented by producers directly working with their broker or through their cooperative. By far, the most popular answer was "10 to 50 percent" with 19 respondents. The second most common answer was chosen by seven respondents and was "Less than 10 percent."

2. Another question was asked about cash forward contracts that producers might use. Cooperatives will almost always offset their risk by selling futures contracts and this volume could also be affected. These responses were more varied, but the most common was still "10 to 50 percent" with 14 respondents; five with "Less than 10 percent"; four with "More than 50 percent"; and four who said they didn't have an informed opinion.

3. We were also interested in producer choice between MPP and LGM-Dairy (Livestock Gross Margin Insurance for Dairy). Most people (13) said that "LGM-D will probably retain as much activity as ever, but many will use the new MPP." The second-largest group of 10 said that "Almost no one will choose LGM-D but instead opt for the new MPP." One person said that "Producers won't use either product to any great extent," and three did not have an informed opinion.

4. Finally, we directly asked what effect the MPP will have on futures markets. Ten folks said "Some impact, all contracts are still viable, but volume will noticeably decline"; nine people said "Minimal impact"; four said "Large impact — lost a great deal of volume"; and one thought it could have a "Positive impact — could stimulate new interest in risk management." Three respondents did not have an informed opinion.

What the future might hold

So, what can we conclude? Our knowledgeable panel thought that hedgers on the sell side (short) represent a significant amount of the volume in the Class III milk contracts, both directly and indirectly, through cash-forward contracts. This may reduce futures volumes if producers find satisfactory risk management through the new MPP. Although producers will have a choice between LGM-D and MPP, most respondents also felt that the new MPP will be the more heavily used option. Most importantly, over half of the respondents believe that the new dairy policy will have noticeable and detrimental impact on the trading volume in dairy futures and options at the CME.

While the farm bill language is now settled, some of the most important details that may determine the magnitude of "crowding out" of private dairy risk markets are, in fact, not yet written. If the Farm Service Agency pursues conservative implementation rules — such as an adequate lead time for sign-up before the calendar year — the issue of "crowding out" could be reduced.

"Let's step outside — I don't want her to hear this."

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