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If production does not matter then why bother to farm, just trade the market![1]

Art,

I went through this very topic yesterday with a couple of my largest insured. The point of adding the HPO only became a value if you have a loss and then only on the lost bushels, as opposed to having a call option on all the bushels marketed. While the cost difference was substantial for both corn and beans. The insured had a valid point, and one that I could not contest at the time, so I am looking for some help. Should growers be looking at eliminating the HPO and applying the savings to an option? Am I missing something?

Crop Agent

Dear Agent,

All Farmer marketing plans assume production, otherwise it is not necessary to be a farmer to follow the plan; a Chicago speculative trader could follow the same plan. The marketing plan that many growers follow by default is storing grain "forever" and then selling at the loan rate but that "plan" also assumes production.

Revenue Assurance with the harvest price option (RA-HPO) will replace insured production at current prices not prices that were forecasted at sales closing. Growers will either produce those insured bushels or have enough dollars to buy back those bushels at current market prices.

It sounds like your clients are executing a synthetic put, i.e. sell futures (open basis or forward contracts) and covering the sales with calls (nothing wrong with their marketing but they do not understand replacement coverage crop insurance).

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The theory of the put is if prices increase growers will sell the crop for more money but the put will expire worthless (with a synthetic put the call pays off but the net is then used to cover margin losses or cancellation penalties and a synthetic put will net about the same as a put) [2]. That is true if the grower has bushels to sell. If the crop fails then RA-HPO will give those "bushels" back for a sale at the higher price. If growers have RA only, then higher prices effective increase their bushel deductible that they have already sold with a put. **If production does not matter then why bother to farm, just trade the market!**

The Harvest Price Option (HPO) in Revenue Assurance (RA) is effectively cheap soybean "calls" on guaranteed insured bushels that are nearly 70 cents in the money. The HPO has a "strike" of $6.72. A call with a strike of $6.80 would cost nearly a dollar a bushel. A grower with a 40 bushel yield guarantee would pay nearly $40 an acre to cover the guaranteed RA bushels without the HPO with call options. Because the current market is so far above the $6.72 RA's base price is the reason one could sell futures, buy puts, synthetic puts, etc. and lock in profits. Relative to the current market, RA-HPO is "cheap" coverage.

It appears growers are trying to save a couple of dollars on their insurance because they don't think the HPO will payoff because they "know" soybean prices will be lower than $6.72 by harvest. If they believe their own price forecast they should buy RA-HPO and combine it with a marketing tool. Based on history there is a 50% chance that soybean prices will be below $6.72 at harvest time but there is also a 50% chance they will be higher. However, a poor crop would drive prices higher and that is the time growers need coverage and RA-HPO would replace those lost bushels at the higher prices. I assume everyone is waiting on $15 beans to sell, but if that is true then the comment on the HPO is just wrong.

Insurance companies should not start writing checks just yet. The "call" in RA is conditional on production. If the grower produces yield and price increases then the CBOT call would pay but HPO would not pay. HPO would only pay on the lost insured bushels, if prices increase. If prices decrease then neither HPO nor calls would pay, but RA would cover **some** of the lost production.

Calls are not a substitute for replacement coverage crop insurance (RA-HPO) and RA is not a substitute for marketing. If growers buy RA-HPO and don't combine it with a marketing tool (market prices currently are about 70 cents higher than the RA base soybean price) then the next best alternative is to buy higher coverages of RA with no HPO. However, this is a poor second as covered in the paper posted at:

http://www.agmanager.info/crops/insurance/price_risk/pr_html04/ABmorehpo.asp

One final thought. **One might want to opt for RA-HPO over the CRC on soybeans this year even if the RA-HPO premium is higher.** The market is so volatile and the RA-HPO has no coverage limits. CRC has a $3.00 maximum limit on price increases and the market is already nearly 70 cents into the maximum limit.

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[2] If the put and synthetic put did not give similar results arbitragers would extract the profits.