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## Student Checking on Dad's Crop Insurance<sup>1</sup>

*Dear Dr. D*

*I was talking to my dad this evening and the question came up if having crop insurance was required. One of the slides in the lecture notes about APH said if you want to count the most recent years in the APH the first thing it said you can do is quit insurance for a year and then come back. This question came up because we have enterprise units and some of them have an APH of 160bu/acre and we have 70% coverage and we feel it would benefit us by not having insurance on certain pieces of ground due to the fact that the odds of us getting the indemnity is not very likely. We would be basically paying the premiums when we really wouldn't need the insurance on these certain units. Therefore my question is; is crop insurance required?*

*Thanks,  
Student*

*Dear Student,*

*Crop insurance coverage is required for participation in certain government programs (I believe the SURE and DCP programs – this will be covered later this semester by your Public Policy Professor). I believe that the only coverage required for those programs is the CAT coverage levels though. Therefore, I would recommend consulting both your*

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*crop insurance agent and FSA office before dropping coverage (and March 15 was the deadline for changes).*

*I'm not certain, but I don't think you can insure some fields and not others of the same crop in the same county. I'm going to copy Dr. Barnaby on this email and ask him to respond and correct me if I'm wrong about this. Dr. Barnaby - can you please comment on this (She is a student in my Ag Economic class at the University).*

*Thanks,  
Professor*

Dear Student and Professor,

Your professor is correct on all of the points. I would expect nothing less from a KSU trained economist!

I would add if you buy CAT coverage, you reduce your SURE coverage. Farmers who buy higher levels of insurance also receive higher levels of SURE coverage. Revenue Protection (RP) insurance buyers receive more SURE coverage than Yield Protection (YP) buyers. SURE APH is often higher than the crop insurance APH if you have had insurance claims. Crop insurance allows farmers to “plug” low yields with 60% X T-yield. Under SURE, farmers get to drop all of the plug yields from their yield history and then average the remaining high yields.

This information on SURE is of no value now because we are past the sales closing date for crop insurance and I don't expect the SURE program to be available for next year's crop. SURE is not funded in the base line and it is currently funding only through 2011. That means Congress would have to come up with new funds for SURE next year when all of the talk is about budget cutting.

Crop insurance is effectively the new “loan rate” for corn, sorghum, soybeans, and wheat. The effective Yield Adjusted Asian put strike price for 70% Corn RP coverage is 70% times \$6.01 is \$4.21. Had your dad purchase 80% RP coverage the effective Yield Adjusted Asian put strike price is \$6.01 X 80% = \$4.80. If the harvest price falls below the effective strike price then the deductible in your RP crop insurance disappears.

The disappearing deductible is why one can sell put options at the effective strike price and have them covered by (or some combination) production greater than the APH, RP indemnity payments, and/or the premium received for selling the put. The costs for those effective YAA puts have premiums in most case that are less than 2 cents a bushel. However, the market value for those out of the money CME puts are selling for 20-30 cents. With recent market pull backs, put premiums have even been a little higher, but put premiums change with daily market prices. YAA put has an effective fixed strike price (\$4.21 in your case) that does not change with the daily market. So you are looking for down days if you want to sell covered puts.

Enterprise units lower the premium costs and they are not affected by price risk. Because of the lower cost, it allows farmers to buy a higher coverage level and increase the effective strike price in RP. A higher percentage coverage level with an enterprise unit is often a better alternative than optional units a lower percentage coverage level. In many cases farmers can replace their “optional” unit spot loss coverage by purchasing private hail insurance. However, there are cases where enterprise units clearly don’t work, e.g. corn farmers with both irrigated and dryland corn acres. If growers have APH total yields that are about the same for both dryland and irrigated corn, this would reduce the level of protection for drought.

I would suggest limit selling of CME puts to no more than 1 CME put for every 3 YAA puts because the YAA puts don’t pay as much as CME puts unless the grower’s yield equals the trigger yield (coverage percent times APH). Farmers selling puts can use the put premium to cover the initial net margin loss and therefore sell their put at a higher strike price for a higher premium. However this does increase the risk.

Farmers may receive margin calls on sold puts, so one needs to plan for the cash flow requirements. YAA puts have no right to be exercised and can only be cashed in at harvest. YAA puts have no time value. The RP settlement price is an average price and for corn settles on November 1. CME puts are spot settled and can be closed at any time. The CME put time value will equal zero at expiration on Corn in late November and earn only intrinsic value. So there is about a 3 week period when the CME put is still in force and the RP contract has expired on November 1. Board traded options are not as liquid as futures; therefore one should only submit limit orders. Also one may need to be patient when trying to get an option order filled.

Those are some of the devil in the details, and why I recommend only farmers who have lost money trading options should consider selling covered puts. For farmers who want to learn, they should sell only one put and hope they lose money. Farmers will learn far more with a loss but they can learn those lessons with one option. Selling 10 options doesn’t increase learning but it does increase the loss. If farmers make money on their first option sale that could be dangerous because they could think they understand the market and that could mean a big loss in the future. Anyone who spends enough time working with markets realizes how little one does understand.

You will find more analysis and details on the YYA options built into to RP coverage on our website, AgManager.info. When compared to Board traded options, the RP provides some protection from falling prices at a much lower premium costs. If you Dad has a crop yield greater than his APH then it is unlikely crop insurance will pay an indemnity payment but that is why it is risk management and not an investment.

Just like your professor discovered, this is a great place to go to graduate school. KSU also has an internet based Master’s degree that is ideal for working adults. Please keep us on your graduate school list.

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