Farmers May Be Next Victims Of Derivatives

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The cornfields of Iowa, Minnesota and many other states may be the sites for the next round of derivatives debacles.

A long way from Wall Street, farmers and grain-elevator operators are struggling to come to grips with the fallout from their increased use of sophisticated hedging instruments in volatile corn and soybean markets. Reports that a number of cooperative grain elevators and farmers are facing cash crunches, large losses, and even bankruptcy are beginning to circulate throughout the cash grain-trading industry across the U.S. Many analysts point to uncanny parallels with higher-profile losses on interest-rate derivatives over the past two years.

"There are clear and significant problems that are multiplying," says Diana Klemme, vice president of Grain Service Corp., an Atlanta-based grain-merchandising and consulting firm. "The complexity of these new grain-delivery contracts has put new risk-management demands on people that maybe they weren't prepared for, and in markets like we've got now, the costs of not managing things properly multiplies."

For generations, farmers have signed grain-delivery contracts with elevator operators, pledging to deliver a certain quantity of their crop when harvested in exchange for a guaranteed price. Elevator operators use futures traded on the Chicago Board of Trade to offset their own risks in buying the grain. But over the past three years, market participants say an explosion of complex forward contracts has turned this staid hedging activity into risky business.

"Some elevators offer farmers a dozen or more different types of contracts, to give the users greater flexibility," says Ann

Please Turn to Page C12, Column 3

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WSJ 12/11/95

Continued From Page C1

Berg, a Chicago Board of Trade director and agricultural-futures trader. "But it's backfiring. Some contracts allow producers to roll forward their hedges almost indefinitely, and the costs of doing that can be onerous."

Take the "hedge-to-arrive" contract, for instance. One of the most popular of the new vehicles, this forward sale agreement binds the farmer to deliver a specified quantity of grain at a certain time in the future. The farmer takes the risk that the price won't rise before he has to deliver against the contract. Historically, prices do fall during harvest months as new crops hit the market.

But this year has been different, as poor growing conditions have led to smaller-than-expected crops, tighter stocks and higher prices for some commodities than have been seen in nearly two decades. That has exposed many risk-management failures by parties to these and other contracts, analysts say.

Some producers are finding that they have hedged more than they are able to harvest and aren't able to deliver against the contracts. Others, reluctant to sell their crops at the low prices that they agreed to early in the summer, are using a provision in the hedge-to-arrive contract that allows them to roll the transaction forward months at a time, to defer the sale of low-priced grain until a time by which they hope prices will fall. In the meantime, they can sell this year's harvest at the new, higher prices.

This is causing a liquidity crisis for grain elevators. To hedge their own exposure, they traditionally sell CBOT grain futures short and cover those positions when the grain is delivered. Now, after paying out hefty sums in margin requirements as prices have risen over the summer and fall, they are facing the possibility that prices could rise even more and that margin calls could make further inroads into their bank lines of credit, even as they fail to receive the grain they had expected to be able to put up against the short positions.

"These strategies were fine and good as long as the market did what was expected and fell," says Dan Basse, market research director at AgResource Co., a Chicago-based commodity-research firm. "But now you've got to wonder how long some of these guys can continue managing things. What happens if we have a weather problem next spring and prices go even higher?"

In Clarkfield, Minn., Tri-Line Farmers Cooperative already faces losses of at least $1.5 million on futures positions. Last week, the grain elevator's board fired its manager, Rod Olson, and launched a suit in Minnesota District Court against Mr. Olson and four local farmers, two brothers, Thomas and Timothy Gilbertson, and Thomas's two sons, Shane and Brett Gilbertson.

In the suit, Tri-Line alleges that Mr. Olson hedged more corn and soybeans for the Gilbertsons than they could possibly produce and that the four farmers never intended to deliver the grain as provided for in the contract. The elevator operator claims Mr. Olson effectively permitted the Gilbertsons to use these forward sales contracts as ways to speculate on future grain prices. Mr. Olson couldn't be reached for comment, and an attorney for the Gilbertsons declined to comment.

"It's been a nightmare here in the month since we found out what was going on," says Tom Listul, chairman of Tri-Line. "In a town like Clarkfield, where you either farm or sell to farmers, the elevator's probably more important than the bank."

While Tri-Line's members grapple with the new concept of counterparty credit risk and Mr. Listul struggles to manage the money-losing CBOT positions, analysts warn that other farmers and grain-elevator operators may find themselves in a similar plight.

"Small country elevators don't have the retained earnings or equity to withstand a $200,000 loss," frets William Dodds, grain-merchandising manager at Andersons Management Corp., a Maumee, Ohio-based elevator operator. While he says he isn't worried about fraud, he says Andersons now asks large growers for production estimates so the company can more easily determine its risks.

In July, the Agribusiness Association of Iowa held a meeting to discuss the new complex products. "We wanted to warn people that if they use these contracts in ways other than they were intended, they're endangering the whole ball of wax," says Randy Allman, general manager of the association. He fears a regulatory crackdown on hedging at a time when the government is encouraging farmers to take on more responsibility to protect themselves from volatile markets.

Some argue farmers already operate in legal limbo. For the past 60 years, regulators have banned them from using so-called trade options, off-exchange derivatives negotiated by commercial users or producers of a commodity. Regulators insisted that any off-exchange contract must contain a provision for future delivery of the grain. This prohibition was aimed at protecting supposedly unsophisticated farmers from potential losses arising from using these over-the-counter instruments to speculate on mercurial commodity prices. That has led some market experts to worry about the legality of some contracts that allow positions to be rolled forward indefinitely.

Proponents of deregulation hope that a Commodity Futures Trading Commission hearing next week on whether to end the trade-options ban will clear the air. At the very least, they say the debate may force farmers, elevator operators and others to take a hard look at their management practices.

"The commercial purpose for some of these contracts has almost disappeared," says Jay Pierce, a CBOT director and agricultural-options trader. "The community needs to open their eyes and know what risks they're hedging against and what ones they're incurring when they use these products."