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RIGHTRISK™

RIGHTRISK NEWS

DATES TO REMEMBER

Forage Insurance
- September 30th

RI-PRF Coverage
November 15th
for 2021 crop year coverage

Acreage Reporting
- November 15th

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How Much Risk is Right for You?

Risk Management Strategies: What to Include

A strategy can be described as a plan of action for using available resources to achieve desired outcomes. Strategies are usually formulated to reach long-term or overall goals and, as such, good strategies become a guide for future decision making and are extremely important to the success of a business.

Broken down into its three most basic components, a strategy involves: 1. a goal, 2. resources, and 3. a method or approach to action. Risk management strategies include each of these three components in a description of how important risks will be addressed by the business.

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Sources of Risk
All agricultural businesses face five primary sources of risk: market, production, financial, human, and institutional. Risk can be formally defined as the effect of uncertainty on objectives. There are events and uncertainties that can affect the objectives and goals of the business across each of these areas of risk.

Determining the significant risks faced by the operation is an important first step when formulating risk strategies. A first draft of the list is just a start. Other risks will come to mind and some of the risks on the list may change as a better understanding is gained of the uncertainties involved and the process of strategy development progresses. Prioritizing the risks would be the next step, helping to identify which to address first and most aggressively.

Goals and Objectives
Objectives establish direction of improvement for things you value and measure. Risk management objectives might include decreasing debt service obligations relative to expected cash available or increasing repayment capacity. Doing so may effectively reduce financial risk.

Goals specify an acceptable target level of achievement for an objective. For example, one measure of repayment capacity is the coverage ratio for term debt and capital lease payments. A coverage ratio of 1.50 or higher is considered a good situation or target. This implies that, for every dollar of scheduled term debt and capital lease payments required, there is at least $1.50 of expected net income available to make those payments. A farm or ranch with a coverage ratio of 1.20 might set an objective to increase its coverage ratio to more than 1.50 within the next two years.

Risk Management Strategies
One of the main benefits of a risk strategy is that it forces the people involved to identify the goals and objectives they are trying to accomplish and consider how they will measure, as well as evaluate how effectively the selected strategy is moving them toward the desired outcome. Risk management strategies are generally designed to do one of four things: 1. avoid the risk, 2. transfer the risk outside the business, 3. control the risk within the business, or 4. accept the risk as part of doing business.

Avoid
Avoiding risk is focused on eliminating or minimizing exposure to uncertainties with potentially unfavorable consequences. A strategy to avoid market risk might be accomplished through a marketing contract that guarantees a specific price for all of this season's production.

Avoiding the market risk altogether may be the preferred strategy if a particular market risk is large enough that it poses an unacceptable threat to achievement of the goal to increase the coverage ratio to 1.50 or higher. A risk strategy might be outlined to allow growing the crop only if a marketing contract is available to guarantee a price that provides the revenue needed to accomplish the goal.

Transfer

Transferring risk outside the business is often accomplished with insurance and contracts. One extreme might call for transferring all of the market risk outside the business using a marketing contract (avoid the risk). However, it is more common for only a portion of the risk to be transferred outside the business. For example, an insurance contract usually includes a deductible component so that the business and the insurer each share in any loss incurred under the policy.

Control

Controlling risk is focused on managing either the probability of outcomes, the impact of outcomes or both. Managing probabilities with the intent to reduce the chances of bad events is likely just good, common sense for most operators. For example, a piece of machinery may break down at any moment. The risk of a machinery breakdown can be controlled by properly maintaining the machine, reducing the chance it will break down and extending its useful life, as well as saving money on costly repairs.

Controlling the impact of risk is accomplished in three main ways: (1) diversification, (2) increase the capacity to bear risk or (3) maintain flexibility in order to reduce the impact of a bad outcome or increase the benefits of a good outcome. For example, diversification by following a practice of growing more than one crop or operating a farm with both crop and livestock enterprises can be a method for reducing the impact on the overall operation when markets turn down or production levels are lower than expected.

In another case, the objective of increasing repayment capacity by raising the coverage ratio is an example of increasing the capacity to bear risk. A coverage ratio of 3.25 provides a much larger cushion for any negative impact on crop revenue than a coverage ratio of 1.40 would offer. However, the cost of carrying such a high ratio would likely offset many of the benefits. Under other circumstances a decision maker may feel that there is not enough information at hand to justify making a clear choice. It may be clear that doing nothing is not the best course either. In such cases, a good strategy may be to commit to smaller changes following practices similar to what were used in the past but retain the flexibility to make further change when it is clear it is warranted.

Accept

Finally, accepting risk can be a good strategy when the potential rewards are great, the negative impacts are small, or the risk management alternatives are cost prohibitive or ineffective. Here management may choose to simply accept the risk as a cost of doing business with the idea that the enterprise will cover the entire cost, should a negative event occur.

Developing risk management strategies is an ongoing part of managing any business. Uncertainties continue to materialize, resource constraints keep on evolving, while some goals are accomplished to be replaced by new goals and objectives yet to be achieved. Actively managing the developing situation is critical for success. Thoughtful, up-to-date risk management strategies that are consulted as change takes place can lead to more informed decisions and progressively more positive results over the long run.

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How much risk is right for you and your operation?