Agricultural Services

Your Business and Risk Management
October 2015

Risk Management is an integral part of managing a farm business. However, managing risk in some instances may be costly - low risk and high returns seldom go together. The problem is that people tend to be risk averse. The level of risk can also reduce the incentives for reinvestment, in some cases to the extent that economic growth is stifled.

Individual farmers have different tolerances to risk. Risk management is about selecting the mix of enterprises, worked within a management strategy, to balance a farmer's risk tolerance with the necessity to make a return. The objective is not to eliminate risk - but to manage that risk in balance with return or cost to the business. One of the consequences of the successive changes we have seen in the Common Agricultural Policy in recent years is a transfer of the responsibility for risk management from government to farmers.

In the past, much of the price risk was borne by government. The system of commodity import tariffs and export refunds combined to provide EU farmers with a degree of protection from fluctuations in world market prices. They remained vulnerable to the risk of price fluctuations within the EU - which tended to result from changes in supply, in a market with an inelastic demand. However, even within the internal market, some risk protection was provided by the intervention system.

Farmers have considerable experience of managing production risk at a farm level with the use of rotations, the choice of different crop varieties, or the use of preventive medicines and pesticides. However, with the reduced levels of intervention support, lower import tariffs and export refunds, farmers have become much more exposed to the volatility in the world market for the commodities they produce. At the same time these markets appear to have been more heavily influenced by the impact of changing weather patterns on supply. As a result, more attention needs to be given, not only to the management of production risks, but increasingly price risks. This applies equally to both inputs and outputs.

The sources of risk are well known. Yields can be affected by weather, pests or diseases. Price movements can be triggered by sudden changes in supply or demand, or by exchange rates. These can have knock-on effects on input costs. Although these may be categorised as production risks, they ultimately create financial risk within businesses.

Managing risk falls into three main categories.

- **Loss control**

This includes the selection of the enterprise mix on the farm, the diversification of income sources or even specific decisions like the choice of variety, or the preventative use of medicines or pesticides. All of which can reduce the exposure to loss

- **Risk Transfer**

Risks can be transferred to third parties. This may take the form of insurance, forward contracting of both outputs and inputs and interest and exchange rate hedging. With interest rates at historically low levels, some businesses are exploring the potential to lock in to these rates to manage this area of risk. The volatility of euro sterling exchange rates has also stimulated an increase in enquiries into forward exchange contracts to manage the potential exchange rate risks, associated with the "single payment".

- **Risk Retention**

Retaining the risk within the business is a legitimate part of risk management. The difficulty occurs when it is not part of a proactive management strategy – but becomes the default position because no risk management has taken place. An example of risk retention could be carrying additional levels of capital reserves in a liquid, readily accessible form to act as a buffer against poor yields or prices.
To assess the degree of financial risk being carried by a business, it is important to carry out some form of planning and budgeting. There is also a need to subject these plans to a degree of sensitivity analysis. The level of sophistication required in the planning process will depend on the complexity of the individual business and the perceived degree of risk.

Many farmers already practice a degree of risk management, although they may not describe it in these words. In a world where costs and prices tend to be volatile, and where the cushion of price support is being reduced, risk management will become a more important part of business planning. This is increasingly being recognised by European government, where its inclusion and promotion as part of CAP support, continues to be debated.

To see how we can help

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