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Finance Overhaul Casts Long Shadow on the Plains

By MICHAEL M. PHILLIPS

Michael M. Phillips/The Wall Street Journal

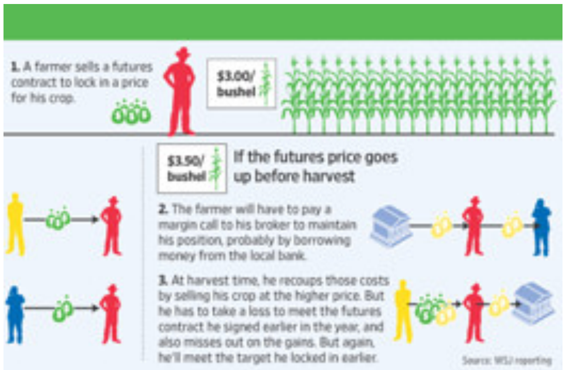
Jim Kreutz, a Nebraska farmer, hedges 70% of his 345,000-bushel corn harvest every year.

GILTNER, Neb.—Farmer Jim Kreutz uses derivatives to soften the blow should the price of feed corn drop before harvest. His brother-in-law, feedlot owner Jon Reeson, turns to them to hedge the price of his steer. The local farmers' co-op uses derivatives to finance fixed-price diesel for truckers who carry cattle to slaughter. And the packing plant employs derivatives to stabilize costs from natural gas to foreign currencies.

Far from Wall Street, President Barack Obama's financial regulatory overhaul, which may pass Congress as early as Thursday, will leave tracks across the wide-open landscape of American industry.

Designed to fix problems that helped cause the financial crisis, the bill will touch storefront check cashiers, city governments, small manufacturers, home buyers and credit bureaus, attesting to the sweeping nature of the legislation, the broadest revamp of finance rules since the 1930s.

How Farmers Use Derivatives



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Here in Nebraska farm country, those in the business of bringing beef from hoof to mouth are anxious, specifically about the bill's provisions that tighten rules governing derivatives. Some worry the coming curbs will make it riskier and pricier to do business. Others hope the changes bring competition that will redound to their benefit.

"Out here we like to cuss the large banking institutions because of the mortgage mess, but we also know that without them some of these markets don't work," says Mike Hoelscher, energy program manager for AgWest Commodities LLC, a Holdrege, Neb., brokerage that provides derivatives services to the farming industry.

Derivatives are financial instruments whose value "derives" from something else, such as interest rates or heating-oil prices. The first derivatives were crop futures, which appeared in the U.S. at the end of the Civil War and became a standard facet of business for companies across America.

During the financial crisis, they became notorious as American International Group Inc. and others were gutted by bad bets on derivatives linked to bad mortgages.

President Obama and other proponents say the financial overhaul will prevent the kind of reckless lending and borrowing that sank the financial system and left taxpayers with the check. They say non-financial companies are worrying unduly about the derivatives portion of the legislation. The Senate is expected to approve the financial regulatory overhaul on Thursday, sending it to the president.

The full impact won't be known for years, but in Nebraska nerves are already on edge.

What's Made It Into the Bill?

For consumers, for investors, for banks and for the government.

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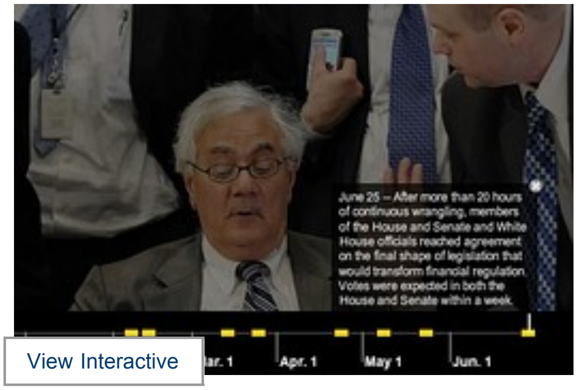
Executives at Five Points Bank in Hastings think the new rules on mortgage lending will make the home-loan business less profitable. "When they create a new regulator, it really scares us," says Nate Gengenbach, vice president of commercial and agricultural lending.

Advance America Cash Advance Centers Inc. thinks the new Bureau of Consumer Financial Protection will take aim at the payday-loan business, though it's not clear what steps the agency will take. Advance America's storefront at the Skagway Mall in Grand Island charges an effective 460.08% annualized interest rate on a two-week $425 loan.

Overhaul Timeline

See a timeline of the legislation's progress.



Akaka to Wyden

Review the senators' current vote plans.

But it's the derivatives portion—the part of the bill aimed directly at Wall Street—that might end up touching most lives in rural America.

The new law requires most derivatives transactions be standardized, traded on exchanges, just like corporate stocks, and funneled through clearinghouses to protect against default.

Faced with intense lobbying, Congress partially exempted businesses that use derivatives for commercial purposes. So, farmers and co-ops probably won't face new collateral requirements, for instance—although there remains a dispute over that section of the bill. Those that trade derivatives on regulated exchanges, such as the Chicago Board of Trade, are less likely to see immediate impacts than those conducting private over-the-counter deals, which will face federal regulation for the first time. The goal is to make such deals transparent.

The question for these farmers is whether such rules will make hedging more expensive. Some say new requirements on big players will create higher costs for small players, including the cash dealers will have to put aside to enter into private derivatives transactions. Some brokers think restrictions on big-money banks and investors will drain the amount of money available to the everyday deals farmers favor.

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Jon Reeson, a feedlot owner, uses derivatives to hedge the price he pays for feed and the price he gets for steer.

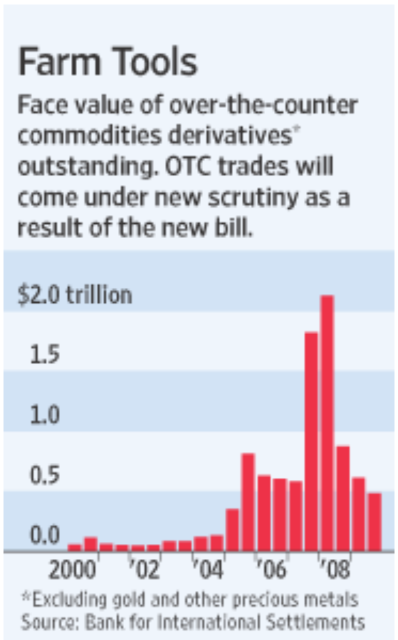
Others predict the opposite effect, pushing money from the private market to the exchanges and creating more competition that will benefit farmers.

Uncertainty reigns in Giltner, a town of 400 residents 80 miles west of Lincoln. At first glimpse, Giltner's landscape seems featureless, a fading horizon of corn and soybeans. But its details are more subtle, including wildflowers and shaded creeks. Everywhere galvanized-steel sprinkler systems crawl across farm fields like giant stick insects.

Mr. Kreutz, an outgoing 36-year-old with a sandy crewcut and sunburned neck, gave up a career in finance and took over the 2,800-acre family farm after his father's death. As he works his fields, he checks the crop futures prices on his smart phone.

Here's how Mr. Kreutz does it: Say in early summer he sees that the price for a Chicago Board of Trade futures contract on corn for delivery later in the year is $3.56 a bushel. If he likes the price, and wants to lock it in, he calls AgWest and sells a futures contract for 5,000 bushels. The futures contract is a derivative in which the price for corn is set now for exchange in the future, though no kernels will change hands. Instead, when the contract nears expiration, Mr. Kreutz and the buyer of his contract will settle—in effect—by check.

By fall, when Mr. Kreutz is ready to deliver his crop to the local co-op, the market price might have fallen by 50 cents. He'll sell his actual corn for that lower amount. But he'll make up the difference through his financial hedge. (Mr. Kreutz buys a new futures contract at the lower price to make good on his earlier promise, making up the 50 cents.) In all, he'll have hit the price target he locked in earlier in the year, minus brokerage fees.



If the price rises during the summer, as it did during the food crisis two years ago, Mr. Kreutz has to pony up extra cash for his broker—a margin call—to maintain his positions. He recoups that by selling his actual corn at a higher price, but has to take a loss to meet the futures contract he signed earlier in the year, missing out on a windfall but ultimately meeting his target price.

Mr. Kreutz does this type of operation dozens of times a year, hedging about 70% of his 345,000-bushel corn harvest.

Such deals ripple through the local economy. When Mr. Kreutz gets a margin call from his broker, he turns to his banker, Mr. Gengenbach, for a loan to cover it. Mr. Gengenbach estimates that one quarter of his farm clients use derivatives.

"Somebody like Jim has a lot of money in his crop out here," says the 37-year-old Mr. Gengenbach. "If he can't protect that, it's not good for us."

Mr. Kreutz's brokerage, AgWest, thinks the new finance law will hurt both firm and farm. If big investors and dealers have to keep more cash on hand, there will be less liquidity in the market and therefore the cost of derivatives will increase, Mr. Hoelscher, the broker said.

A few minutes from the Kreutz family farm are the corrals of Jon Reeson's feedlot. Mr. Reeson, 43, is married to Mr. Kreutz's sister Jane. His feedlot holds as many as 1,500 steer, mostly Black Angus, which grow from 600-lb. calves into 1,300 pounders ready for slaughter.

Mr. Reeson uses derivatives to hedge both the price he pays for feed and the price he gets for selling his steer.

The fattening takes about 7,000 pounds of food for each animal. Mr. Reeson can't count on a favorable price from his brother-in-law's farm, in which he has a stake, so when he sees a feed price he likes, he seals it with a futures contract.

In April, he called AgWest and locked in a price with a futures contract for $95 per hundredweight of cattle. Since then the market price has dropped to $90. If the price stays there until October, he'll have made the right call, earning a higher price than if he'd relied on the market alone. If the price spikes higher, though, he'll miss out on potential gains.

Mr. Reeson is willing to live with that possibility in exchange for locking in a profit or a narrowed loss. Derivatives hedging helped him survive the recession of 2008-2009, when cash-strapped diners avoided steak and the price of beef plunged.

He's watching the new legislation warily and can't yet tell if it will hurt or help.

When his cattle have reached full weight, Mr. Reeson puts them on Roger and Barb Wilson's trucks for the trip to the slaughterhouse. The Wilsons have seven semi tractors and 16 trailers, and one of their biggest costs is diesel fuel to keep the fleet on the road.

In 2004, Cooperative Producers Inc., his local co-op, offered Mr. Wilson a price-protection plan for 10,000 gallons of diesel at about $2.50 a gallon, with 90 days to use it.

CPI had a choice. It could take its chances and hope the price of fuel would drop before Mr. Wilson took delivery on his full order, a windfall for the co-op. If diesel prices jumped, though, the coop would take a bath. "That falls under speculation," says Gary Brandt, CPI's vice president of energy. "But that's not what cooperatives do. That's what Goldman Sachs does."

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Black Angus cattle at Jon Reeson's feedlot in Giltner, Neb.

Instead, CPI hedged on the New York Mercantile Exchange, buying a futures contract on heating oil, a close market substitute for diesel fuel. The co-op goes a step further and hedges also the difference between the prices of fuel traded in New York and delivered in Nebraska.

For the 57-year-old Mr. Wilson, the pricing plan proved a mixed blessing. The first year, the pump price shot up by another 20 to 25 cents, meaning he was getting a good deal. The following year the pump price dropped about a quarter a gallon, but Mr. Wilson was obliged to pay the higher price. "It hurt to have to pay for that fuel," he recalls sourly. He quit the program after that.

The finance law's imminence has prompted CPI's Mr. Brandt to warn his sales team and customers that the co-op may have to end its maximum-price fuel contracts. He's worried too that CPI might have to cut its fuel supplies if it can't hedge against price drops.

"We have to start making a game plan if they take away the ability for us to hedge that inventory," Mr. Brandt says.

The Wilsons deliver Mr. Reeson's steer to a low, cement-gray complex on the edge of Grand Island, Neb., where trucks arrive loaded with cattle, and others leave loaded with meat. Over the past year, Mr. Reeson has sold 1,125 steer to the packing plant, which is owned by JBS USA, a Greeley, Colo., unit of Brazilian-owned JBS SA.

JBS buys livestock two ways. Sometimes it pays cash for the following week's kill. Sometimes it buys further forward, agreeing in July, for instance, to a fixed price for steer delivered in December. JBS hedges on the derivatives market to make sure live cattle prices don't drop before it takes delivery.

The company also sells beef cuts forward to restaurant chains, promising delivery at set prices months ahead of time. JBS expects to have enough meat to fulfill the agreements. But if it runs short, it doesn't want to risk having to pay higher prices to buy meat to supply those restaurants.

So, it uses the derivatives market to play it safe. To do so, the company has to find a way to hedge different cuts of beef: Tenderloins might represent 1.5% of the total value of a steer. Strip loins might make up 3%. In a sense, JBS protects itself by reconstructing the steer through a derivatives trade on the Chicago Mercantile Exchange. "We try to put the carcass back together financially," says company spokesman Chandler Keys.

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Financial Regulation Watch

The company hedges electricity for its refrigerators and natural gas for its boilers. It hedges currencies to stabilize its income from overseas. It hedges fuel for its fleet of thousands of trucks.

Even executives at a big firm such as JBS haven't been able to nail down the precise impact of the legislation on their business, introducing an unaccustomed level of uncertainty into their operations. They aren't changing the way they use derivatives, yet, hoping instead that exemptions for commercial users will insulate them.

"To get food, particularly highly perishable food like meat and poultry, through to the consumer, you have to manage your risk," says Mr. Keys.

—Sarah N. Lynch contributed to this article.

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