October 1, 2009

TO: North Dakota Public Service Commission
FROM: North Dakota Grain Dealers Association
RE: Comments in reply to September 10 memo re August 21 meeting on grain elevator bonding.

The record of grain elevator insolvencies and farmers losing money in this state is admirable. There have been few of them. Most of the problems in recent years have not been with typical grain elevators. They are more likely with processor type operations such as Verasun in Hankinson or the canola processor in Northwood. It is not unusual for new industries to have some startup problems. Another factor is thin markets and lack of liquidity in some of these specialty crops as compared to the bigger and more liquid markets in traditional crops. Another factor is the lack of risk protection mechanism in some crops as compared to the long-established futures markets in, for example, wheat, corn and soybeans. We're told that what got Verasun in trouble was when it abandoned its traditional market risk management practices.

The North Dakota Grain Dealers Association has written grain elevator bonds for several decades. I was told by my predecessor that it started because these bonds are a specialty item – unlike millions of homeowner or car insurance policies – and bringing a bunch of customers to a bonding company made taking on this line of business worthwhile. I've been an agent for the NDGDA agency for 30 years. I started writing for Transamerica, which was sold to Continental Insurance, which is now part of CNA Surety.

Bonds and insurance are different animals, even though some companies write both. An insurance policy is a two-party deal, the insurance company and the insured. Losses are expected and the premiums reflect that. Car insurance on a 20 year-old costs more than on a 50 year-old because history shows there will be more losses. On the other hand, surety is a three-party deal. In this case it is the surety company, the grain elevator, and the PSC representing the elevator's customers. The theory of bonding is that the underwriting will be tough enough so there will be no losses. We all know that is an imperfect theory. The premium on a bond is very low compared to insurance. It covers the surety company's underwriting costs, other expenses of its various offices, re-insurance cost, agency commissions and likely more I'm not aware of. I know of one single station elevator that spends $2800 for its warehouse bond vs. $75,000 for its property and casualty insurance. A much larger multstation company spends $6000 for its bond vs. about $280,000 for its property and casualty insurance.

And now on to the options:

1. Keeping the status quo for grain warehouses and facility-based grain buyers is fine with us. Someone said at the August 21 meeting that North Dakota bond requirements are already head and shoulders above those of other states. In 1999 the PSC reduced bond requirements. Reason was to keep grain elevators in the state system instead of chasing them to the cheaper federal system. This way problems are dealt with in Bismarck instead of through USDA Commodity Credit Corporation offices in Kansas City. We need to keep that in mind now too.

2. Establishing a separate licensing category for processors is fine with us. Those have been most of the problems and the three cases now active are processors.

The statute [60-02-09(1)] says the bond must be at least $5000. The PSC has set the warehouse bonds much higher than that in 69-07-02-02 and the grain buyer bonds in 69-07-02-02.1. The PSC has authority under both sections to require more to accomplish the purposes of the ND Century Code. It could raise the bonds or processors by rule or target by order those it decided were inadequate.

3. Basing the bond on volume would be quite a change. The bond amounts required for each volume level must be evaluated carefully for what it accomplishes and the cost/availability of bonds. Basing the bond on commodity value would be an even more significant change and might create its own set of problems. Volatile upward movement in commodity prices could lead to bonding requirements that would disqualify some grain elevators, resulting in bond cancellation, leaving zero protection. The PSC or legislature mandating higher bonds does not necessarily make access to the higher limits possible. Like a lender, a bonding company will look at the customer's net worth, working capital, debt, history of profitability and other factors when evaluating the amount of risk it wants to take.

4. Having the PSC collect financial statements implies that the PSC will have to hire savvy people to review these financial statements. That costs money. Cooperatives provide their members with financial statements. Sole proprietorships, partnerships, and non-public corporations will likely have reservations about providing financial statements to a public entity. Those statements might then become open public record. The bonding companies require submission of financial statements as needed and have experience reviewing them. This screening process is already being done in the private sector.

Another question arises about the state collecting grain elevator financial statements. What happens if the elevator is having a bad year? What are the criteria for taking some action and what will that action be? Going through a low point of financial results and bouncing back to continue serving customers is quite common. Will someone be pulling the plug unnecessarily?

5. This is moving away from surety bonds to a broader indemnity pool and requiring the submission of financial statements. Here again the PSC will have to have people on staff to review these statements and decide when and what action should be taken if there is a supposed problem. A primary purpose of a surety bond is to serve as a screening device so that only adequately-capitalized firms get in the business. An indemnity pool without a screening device means the good apples are paying for the bad apples. This could lead to an overall deterioration in the average financial strength of grain elevators. It was brought up a number of times during the August 21 meeting that farmers must know who they are doing business with and should not do business with unstable companies. A couple examples were given where some fly-by-night was paying way more than the market and then collapsed, leaving sellers holding the bag. Elevator managers report having told their customers to be wary of somebody down the road who is bulling the market. Sue Richter said one customer of a defunct firm admitted later he should have known better. State policy should not encourage doing business with unstable firms by underwriting potential losses to those firms.

6. <u>This is to expand the pool of assets available in an insolvency.</u> Commissioner Clark hit the nail on the head when he said at the meeting that bankers will object to this. I have visited with some elevator financiers and that is absolutely correct. It will "significantly and adversely affect grain elevator financing" in the words of one, and echoed by others, because "assets pledged as collateral for such financing would be transferred to the trust…without regard to the security interest of the secured party." Reassigning first position in available collateral could mean a reduction in credit lines or no credit lines at all for some. An experienced representative of one company that has been financing grain elevators in North Dakota for most of a century said the commodity price volatility of the past two years meant some credit lines were extended to multiples of usual limits. Without sufficient collateral that would not have been possible. Without sufficient credit lines some elevators could not have kept up with margin calls to maintain their futures market risk protection. The result of that could have been catastrophic.

7. <u>This is for the Bank of North Dakota to become the bonder of last resort.</u> In other words, firms that do not qualify in the private bond market would be shifted over to a liability of the Bank of North Dakota. That sounds like a bad idea to us. You can't have it both ways. You can't have adequate bond requirements for most, but then allow those who are not eligible to somehow come in the back door. This sounds like what happened in the subprime mortgage market when unqualified individuals were given a different route and now the rest of us are paying for it.

8. We are not familiar with this use of <u>private sector receivables insurance</u>. Most likely the writers of such insurance would want to assure themselves of the risk they were covering by getting financial statements on the grain elevators the buyers of this insurance are doing business with.

In conclusion, the business world is not without risk. That has become even more apparent in the past 18 months in the U.S. economy. Farmers have the option of being paid for their grain upon delivery. When they store it or put it on credit-sale contract they are assuming a risk that the buyer can and will make good. When an elevator sells crop inputs and services on credit to a farmer that elevator is taking a risk that the farmer will make good and pay. The current bonding setup provides some financial screening and some dollars if a calamity occurs. The indemnity fund plugged the hole of credit-sale contracts. The system has worked pretty well and major revisions should be undertaken with very careful consideration of the good they will do and the possible adverse consequences.