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**Investment and financial policies for accessing financial  
resources for commodity-based development, including  
with respect to official development assistance, Aid for Trade  
and other possibilities**

**Access to commodity finance by commodity-  
dependent countries**

Note by the UNCTAD secretariat

*Executive summary*

Due to the highly credit-dependent nature of commodity trade, inadequate access to finance has usually constrained the commodity productive capacity and trade of many commodity-dependent developing countries, in particular the low-income ones. These countries tend to have more limited access to credit, which is often available at higher costs with sometimes onerous conditions. This background note examines the sources of, and access to, commodity finance and how these have been affected by the crisis, as well as tools and instruments that could be used to improve access to commodity and trade finance. The paper also raises policy-related questions that need to be addressed in order to meet the commodity financing requirements of smaller players in low-income commodity-dependent developing countries.

## Introduction

1. More than 50 developing and least developed countries (LDCs) depend on three or fewer commodities for at least half of their export earnings. As this commodity trade is highly credit dependent, inadequate access to finance has usually constrained the development of the sector in many developing countries, particularly the least developed, which tend to have more limited access to credit and often face more onerous conditions. The global financial crisis triggered in 2008 has exacerbated the problems of trade finance and investment in the commodities sector.

2. Facilitating access to finance and increasing investment is of the essence for commodity production and trade; it is crucial to the livelihoods of the most vulnerable producers and exporters within the commodity supply chain. Together with the emergence of newer threats bearing directly on the commodity sector (i.e. food and energy security and climate change), the global crisis has underscored a crucial need to understand the problems faced by small-scale producers and exporters of commodities, and to scale up the financial resources required in commodity-dependent developing countries. The need to design appropriate policies and mechanisms to enhance access to commodity finance in low-income commodity-dependent developing countries has never been more urgent

3. This paper examines the issues relating to access to finance for commodity-based development<sup>1</sup> in the context of the recent financial crisis and identifies some potential solutions. It also raises some policy questions that could provide a framework for deliberations. Section I briefly discusses the effects of the crisis on sources of finance, while section II takes up the traditional sources of finance and the financing arrangements that have evolved in response to the crisis. The mechanisms for financing commodity trade are the subject of section III, while section IV highlights the potential impact of risk on the availability of commodity finance and the instruments developed to mitigate some of these risks. The penultimate section draws attention to how current developments in financial sector regulation are impinging upon commodity trade finance. Section VI concludes with a brief discussion of some policy challenges and directions.

### I. Effects of crisis on sources of finance

4. The commodity market boom that gathered momentum from 2005 onwards increased interest within the global banking and financial markets for commodity trade finance. Until early 2009, and before the effects of the financial crisis were felt, the global commodity trade finance market grew significantly, bringing new financial inflows to commodity-dependent developing countries. Large cross-border financings grew in scale and financial liquidity was enhanced by syndication lending with banks joining together, notably in pre-export financings in the Russian Federation (largely oils and metals financing) and Africa/Latin America. At that time individual and syndicated trade finance transactions by bank consortia reached billions of dollars.<sup>2</sup>

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<sup>1</sup> See Accra Accord, para. 93, TD/L.414, 25.04.08.

<sup>2</sup> Many of the banks that participated in these large transactions with substantial commodity trade finance units had to be rescued or restructured to avoid collapse following the crisis, resulting in a withdrawal of capacity from the sector.

5. However, since the second half of 2008, as the financial crisis took hold, trade finance – like global finance more generally – began to dry up, while the cost of credit increased considerably.<sup>3</sup> In addition, the financial contagion spreading within the global banking sector and a threat of bank defaults resulted in a significant deterioration within the inter-bank market, further squeezing supply-side credit. By early 2009, trade financing had fallen to much lower levels than a year earlier.

6. To address the crisis, governments undertook new efforts to support alternative sources of finance in order to fill the gap created by the near-exit of the banking sector from commodity trade finance. Interventions by governments and multilateral institutions have helped to mitigate the situation by increasing liquidity and providing risk mitigation support. Several trade finance programs were introduced as a result of a major pledge by the Group of Twenty (G-20) leaders of \$250 billion in support of trade finance in April 2009.<sup>4</sup> There has also been a growing emphasis on funds provided by export credit agencies (ECAs) and development financial institutions (DFIs), official development assistance (ODA), Aid for Trade and South–South financing.

## II. Public and private sources of commodity finance

### A. ECAs and DFIs

7. Since the global financial crisis, ECAs have increased in importance and their financing has become more essential as banks tightened lending criteria and increased their requirements for risk mitigation tools.

8. ECAs are export credit and credit insurance providers that usually began as national public institutions to support exports. Today, ECAs are a mix of both private and public sector institutions with both national and cross-border operations. Whilst short-term credit insurance in OECD (Organization for Economic Cooperation and Development) countries is mainly privatized, in developing countries ECAs engaged in direct lending or political risk insurance activities tend to be state owned. In some cases state-owned ECAs are being used to as a tool to contain the present financial crisis in commodity-dependent developing countries.

9. ECAs continue to innovate and expand their business, including in regions where international commercial banks do not have a physical presence. ECAs in these regions provide not only credit and political risk insurance but also direct loans. For example, a number of ECAs in Asia have offered new flexibility by providing comprehensive cover on a 100 per cent basis for non-payment risk on bridging loans, instead of the traditional 80 per cent. They are now also taking refinancing risks and cover on domestic projects.

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<sup>3</sup> Interest rates on trade credits climbed far above bank refinancing rates with deals offered at more than 300 basis points over interbank refinancing rates in late 2008–early 2009, which was three times or more the previous year's going rate.

<sup>4</sup> For example, the International Finance Corporation (IFC) increased its Global Trade Finance Programme (created in 2005) ceiling from its original ceiling of \$1.5 billion to \$3 billion, and introduced a new programme, the Global Trade Liquidity Programme, aimed at raising \$5 billion from G-20 members and international finance institutions to be directly lent to emerging market importers and exporters. The programme mixes government and private sector bank funds and then onlends money via global banks to local banks, who in turn lend to small and medium-sized enterprises (SMEs).

10. In sub-Saharan Africa, ECA-backed export finance has been applied to a number of transactions including in the power, fuel and infrastructure sectors.<sup>5</sup> Prior to the global crisis, these transactions would have been funded using structured trade finance facilities offered by banks, such as securing financing with offshore receivables. These transactions were not typical ECA funding targets, and this shows the diversification of ECA activities since the onset of the financial crisis.

11. It is important to note that whilst ECA financing has become attractive, it takes longer to arrange than structured commodity and trade finance packages. Information requirements are more demanding, which may pose problems for some projects.

12. Development banks have also been very active in supporting infrastructure development and facilitating commercial activities and trade. Nearly all of them expanded or developed their trade finance activities, modeled on the pioneering European Bank for Reconstruction and Development (EBRD) Trade Facilitation Programme, which provided guarantees to international banks confirming letters of credits issued by EBRD-selected local banks in transition economies. In the Commonwealth of Independent States, where there have been weak banking systems and a lack of credit insurance, this has been one of the very few instruments available to make local credit risks acceptable internationally.<sup>6</sup> A similar programme is the \$3 billion IFC Global Trade Finance Programme, supporting local banks' trade finance operations in developing countries and particularly in Africa.<sup>7</sup> In addition, the Asian Development Bank has expanded its Trade Finance Facilitation Programme to \$1 billion, a move that could generate up to \$15 billion in much-needed trade support by the end of 2013.<sup>8</sup> Also, the African Development Bank has introduced a Trade Finance Programme similar to those of other DFIs.<sup>9</sup>

13. To summarize, ECAs and DFIs play an active role in helping the private sector and bankers in particular to improve their risk-adjusted returns, and they provide producers and exporters with new opportunities and tools to mitigate risk. However, given the sharp contraction of private capital flows to developing countries from more than \$900 billion in 2007 to \$200 billion in 2009, the interventions by ECAs and DFI are relatively modest, and therefore far from sufficient. Other means such as ODA, and Aid for Trade in particular, are needed to cover part of the huge shortfalls in trade finance, otherwise commodity producers and exporters in developing countries will continue to suffer from lower levels of access to finance to the detriment of their development efforts.

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<sup>5</sup> For example, the South African export credit agency has become more active in the mining sector of the region, including in Zambia and other countries where there are mining-related deals to be financed.

<sup>6</sup> <http://www.ebrd.com/apply/trade/about/index.htm>

<sup>7</sup> <http://www.ifc.org/ifcext/gfm.nsf/Content/TradeFinance>

<sup>8</sup> The Trade Finance Facilitation Programme offers loans and guarantees through international banks and developing member country banks to support trade. Transactions can range from short-term letters of credit to maturities of up to three years.

<sup>9</sup> The African Development Bank acted quickly, devising a two-tiered programme including a \$1.5 billion Emergency Liquidity Fund in support of financial institutions in Africa, and a \$1 billion Trade Finance Initiative, half of which is directed at supporting the use of letters of credit facilitating trade, and the other half under the auspices of the IFC's new Global Trade Liquidity Programme in support of SMEs and intra-African trade.

## B. Official development assistance and Aid for Trade

14. Low-income commodity-dependent developing countries tend to rely on concessional loans and grants from bilateral and multilateral donors for their economic recovery. After two years of decline since its peak level in 2005, the total net ODA from OECD Development Assistance Committee (DAC) member countries reached a new record of \$121.5 billion (at current prices) in 2008. The total net ODA provided by DAC donors to LDCs rose by 14.2 per cent in real terms to \$23.3 billion.<sup>10</sup>

15. Despite the increases in aid levels, compared with the United Nations ODA target of 0.7 per cent of gross national income (GNI), 2008 total net ODA represented only 0.31 per cent of donors' combined GNI. Among 22 DAC member countries, only five countries exceeded the United Nations target. For large donors such as Japan and the United States, net ODA only represented 0.19 per cent of their respective GNI. Despite the commitments made following the Monterrey Consensus of 2002, bilateral donors are not able to meet their ODA pledges. There is still a substantial gap between actual ODA inflows and levels that may be required to meet the Millennium Development Goals.<sup>11</sup>

16. In terms of distribution by sector, the official bilateral commitments by DAC donors in production sectors stood at \$7.6 billion in 2008, a record level over the last decade. Compared with 2007, the rise was mainly due to the increase of ODA to agriculture, industry and mining. However, it should be noted that in real terms, the 2008 bilateral ODA in production sectors and agriculture (including forestry and fishery) was still much lower than its level in the 1980s and the early 1990s.<sup>12</sup> The Food and Agriculture Organization of the United Nations has recently estimated that filling the gap in public investment to help build a more productive agricultural sector in the developing world would require between \$40–\$50 billion per year. This would amount to 17 per cent of ODA if donors achieved their 0.7 per cent.

17. Aid for Trade is part of overall ODA targeted at trade and trade-related programmes and projects.<sup>13</sup> It is particularly important for low-income commodity-dependent developing countries as it addresses their supply-side constraints and builds their productive capacity.

18. The OECD/World Trade Organization (WTO) publication *Aid for Trade at a Glance 2009* examined the progress of the Aid for Trade initiative since its launch at the 2005 Hong Kong WTO Ministerial Conference. In 2007, the total new Aid for Trade commitments from bilateral and multilateral donors reached \$25.4 billion, a 21 per cent increase in real terms from the 2002–2005 baseline period average. Economic infrastructure and productive capacity-building dominated the overall volumes of Aid for Trade. Many commodity-dependent economies are beneficiaries in this respect. A noticeable fact in 2007 was that while the overall level of Aid for Trade was rising compared with 2006, the total commitments from bilateral donors decreased by 2 per cent in real terms.<sup>14</sup> The share of low-income countries in total Aid for Trade was still limited, though it grew to 54 per cent in 2006–2007. While the short-term impact of the financial crisis on the commodities sector

<sup>10</sup> Data extracted from the OECD online database OECD.Stat on 11 December 2009.

<sup>11</sup> UNCTAD (2010). Contribution and effective use of external resources for development, in particular for productive capacity-building. TD/B/C.11/EM.1/2. Geneva. 22–24 February.

<sup>12</sup> Data extracted from the OECD online database OECD.Stat on 11 December 2009.

<sup>13</sup> [http://www.wto.org/english/tratop\\_e/devel\\_e/a4t\\_e/a4t\\_factsheet\\_e.htm](http://www.wto.org/english/tratop_e/devel_e/a4t_e/a4t_factsheet_e.htm)

<sup>14</sup> World Bank /IMF (2009). *Global Monitoring Report 2009*.

has been substantial, the long-term aims of Aid for Trade are to diminish commodity supply-side constraints by building infrastructure, supporting diversification and diminishing trade transaction costs. Aid for Trade can therefore contribute to overcoming the impact of the crisis, in particular if it is “additional” to normal ODA flows.<sup>15</sup>

19. Development assistance is still facing many challenges, including a need to increase aid effectiveness, improve aid predictability (and therefore reduce volatility) and focus on low-income countries. In addition to these, it is important not only to increase ODA and Aid for Trade, but to sustain them at a level that meets the needs of poor countries. The need to respond to these challenges has become more urgent in the context of the current financial and economic crisis.

20. Concerns with the challenges of ODA, in particular with its shortfalls and volatility, have led to the search for complementary sources of finance to support the general development efforts, including commodity financing needs, of low-income developing countries. In recent years, attention has focused on domestic financial resource mobilization and South–South financing.

### **C. Domestic financial resources<sup>16</sup>**

21. The unpredictability and volatility in external resource inflows, including ODA, underscores the dangers of relying too heavily on these flows to finance development in low-income countries. Indeed, as illustrated by the current financial and economic crises, finance from these sources can easily dry up when needed most. This has drawn attention to the need for these countries to increase public revenues through concerted efforts aimed at domestic financial resource mobilization as a means for increasing development finance. Domestic financial resources are more stable than external capital inflows. In Africa, for example, UNCTAD estimates suggest that ODA is up to four times more volatile than domestic tax revenues. Thus, if low-income commodity-dependent countries mobilize more financial resources domestically, part of these could be channeled into financing commodity trade and related investments.

### **D. South–South financing**

21. Over the past 10 years, South–South trade has grown substantially, with more than 50 per cent of developing country commodity trade being accounted for by buoyant demand from Asia.

22. Increased South–South trade brings benefits right across the supply chain, as well as potentially adding to investment capacity (including through technology transfer and know-how) and trade-related infrastructure development.

23. The financial crisis has increased the need to look at ways South–South financing can be encouraged. Some leadership has been provided by financial institutions and

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<sup>15</sup> OECD/WTO (2009). *Aid for Trade at a Glance 2009: Maintaining Momentum*.

<sup>16</sup> These are broadly defined as public revenues, remittances and savings from reductions in capital flight. For further details, see UNCTAD (2007). *Economic Development in Africa: Reclaiming Policy Space – Domestic Resource Mobilization and Developmental States*. United Nations publication. Sales No. E.07.II.D.12. New York and Geneva; and UNCTAD (2009). *Enhancing the Role of Domestic Financial Resources in Africa’s Development: A Policy Handbook*. UNCTAD/ALDC/Africa/2009/1.

development banks in developing countries, by offering new lines of credit, clearing arrangements and letter of credit confirmations. The Africorrbanking scheme by offered by Afreximbank is an example of such a mechanism, and likewise the Organization for Petroleum and Economic Cooperation (OPEC) Fund for International Development (OFID) has introduced tools in support of trade finance for beneficiary countries to alleviate their difficulties in accessing credit.<sup>17</sup>

24. A further example of South–South financing is the recent deal involving the China Development Bank and Chinese oil company Sinopec with Brazilian Petrobras, to lend \$10 billion for up to 10 years’ worth of oil. The flow of funds into Brazil has positive ramifications for Brazil’s developing commodity sector from both a trade finance and an investment perspective. In another example from the metals sector, Chinese investment in Peru is extending to the development of a new mine in Toromocho in the Andes, port infrastructure at Callao and rail/truck facilities between the two locations. This example of a Chinese supply chain financing approach embraces the need for direct infrastructure investment alongside ongoing trade finance facilities.

### III. Financing mechanisms

25. As well as increasing the source of funds, it is important to encourage the development of new financing instruments and mechanisms, by far the most important of which are structured finance mechanisms that encourage banks to finance borrowers throughout the supply chain (i.e. producers, transporters, processors and buyers/end users). Moreover, the development of new financial mechanisms is crucial for small-scale producers and borrowers, so that they can use their underlying stocks or future harvests for collateral purposes.

26. Cross-border trade finance structures can be complex. However, at the small producer or exporter level, the likelihood is that a domestic bank, microfinance or other financial institution involved in lending would simply require confirmation that the commodity to be financed is safely and securely stored and that the borrower will not or cannot easily default. The former requirement could involve the use of collateral instruments, while the latter will require careful attention to loan documentation and the likely reliability of the borrower. Transactions could be supported by collateral instruments, such as a warehouse receipt to be pledged to the bank, or, for larger value transactions, the use of a collateral manager. Also, lenders are keen to ensure that an off-taker with a good payments track record is available to purchase the goods.

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<sup>17</sup> OFID provides funding on its own or in partnership with other institutions. OFID’s commitment typically varies from \$5 million to \$50 million per transaction. By virtue of its mandate, which emphasizes support to countries other than OPEC member countries, OFID does not promote trade in its shareholding countries but could fund imports from, or exports to, OPEC countries if the transactions originate in eligible countries. OFID uses a number of instruments for its trade financing and trade facilitation operations. These include lines of credit to financial intermediaries to fund trade-related advances to local companies, guarantees to international confirming banks for letters of credit (or other instruments) issued by local banks, loans to governments and companies for strategic imports (e.g. food, oil and capital equipment) or to support exports (especially agribusiness) and, finally, structured trade finance, such as in the case of commodity export funding.

27. It may be useful to consider other financing tools as well, however. Equally, it may be important to look at ways credit enhancement instruments might be used, including, for example, insurance products/derivatives to mitigate credit risk, political risk or weather risk as discussed below. The following section reviews in more detail the main commodity finance instruments and mechanisms.

### A. Supply chain finance

28. As mentioned earlier, the development of packaged supply chain financing products is of growing importance. Basically, lenders can provide tools and instruments to serve the entire producer-to-consumer supply chain. The financing approach starts at the production/upstream level, involving crop loans, through to dealers and distributors right down to consumers/downstream.

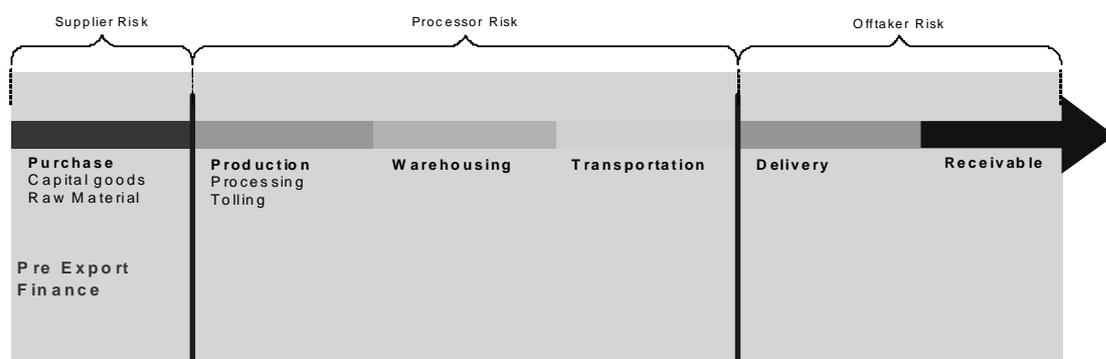
29. In supply chain financing structures, the challenge is for banks and service providers such as collateral managers to build product linkages within the entire supply chain structure itself. This can be a complex undertaking. In developed countries this approach may be managed by banks servicing clients using supply chain technology products, whereas in larger developing countries like India, finance could be provided by commodity buyers such as supermarket chains and processors, rather than banks.

30. Of the components available within the supply chain, structured commodity finance is of great importance because it may allow producers and exporters to raise loans based on the value of their underlying collateral. Structured commodity trade finance transactions are “self-liquidating”, i.e. the proceeds of the underlying commodity are used to directly pay off the bank loan(s) used in the transactions(s).

### B. Structured commodity finance

31. Of most importance to producers and exporters of commodities is the development of pre-export finance structures. Figure 1 below shows how structured trade finance products developed within banks affect the production and storage phases of the supply chain cycle. Pre-export structures deal with production/supply risk, whereas ownership-based finance deals with storage/processor risk.

**Figure 1. Structured trade finance: pre-export finance within the supply chain**

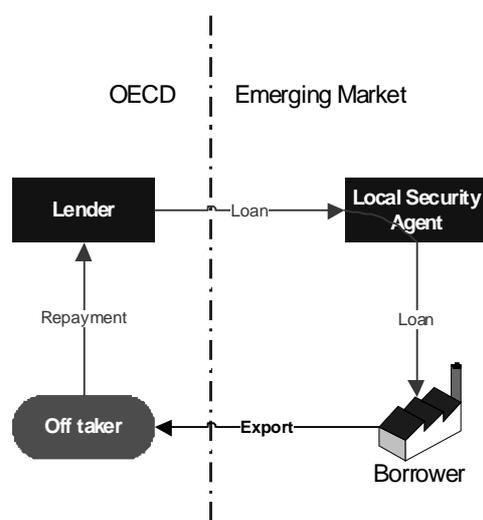


32. During 2007–2009 the total number and size of individual pre-export finance (PXF) deals grew substantially, thereby enhancing financial liquidity. As discussed earlier, this was mainly the outcome of syndicated lending undertaken by some major banks across the globe.

33. Figure 2 shows how a PXF structure works in a simplified form. The essence and strength of the structure lies in the use of a local security agent, which is usually a local bank in the borrower's country. The security agent ensures that the collateral for the loan (the commodity itself) is secured properly and that the loan documentation and other requirements for borrowing are properly fulfilled according to the lender's security instructions. The security agent is then responsible for releasing the loan passed through it from the lender. The lender receives repayment for the loan directly from receivables paid by the off-taker normally into an offshore escrow account.

34. Although the PXF structure seems simple, a lot of careful structuring must take place to ensure that the local security agent is able to fulfill the lender's requirements, for example in managing loan documentation and securing the underlying commodity collateral (managing, inter alia, pledge of warehouse receipts, collateral management agreements and other forms of supporting security).

**Figure 2. Simple PXF structure**



### C. Collateral control structures: inventory finance

35. Moving on from PXF, there is a need to provide finance at the stockholding level. Since the 1990s, many development and national policy initiatives have focused on warehouse receipts financing as a means of improving the prospects for commodity producers. However, warehouse receipts are usually of more importance within supply chain finance as a tool for financing exporters or processors (see fig. 4 below).

36. The essence of a warehouse receipts financing structure is that the borrower is able to deliver stocks to a public warehouse in order to receive a warehouse receipt confirming that the commodity is of a given amount, quality and type. This is in turn pledged to a bank to raise financing.

37. Basically, warehouse receipts are issued by an authorized public warehouse operator, who is a person or corporate entity that accepts goods/commodities from third parties for storage at its premises. A public warehouse operator should only store the goods/commodities of third parties and not for his own account. A public warehouse operator can only issue warehouse receipts if he is licensed to do so. The rules for the management of public warehouses are often enshrined in the codes of countries using a civil legal system.

38. For a warehouse receipts system to work, not only does national legislation have to be in place, but there also needs to be a willingness among local banks to lend. After all, the bank does not want to end up in possession of the borrower's goods, so it will be crucial to ensure that there is a contract of sale for the goods (the proceeds of which will repay the bank loan) and that the pledge from the borrower to the bank is effective.

39. Warehouse receipts can be of two different types: negotiable or non-negotiable.<sup>18</sup> Negotiable warehouse receipts are legal documents of title; they can be used as collateral, i.e. they can be pledged to banks to raise finance, or they can be traded among bearers or on a "spot" exchange.

40. The primary barrier to the introduction of warehouse receipts systems is a lack of enabling legislation. Once warehouse receipts are negotiable and enshrined in law, they can be traded on exchanges. Developing country commodities exchanges use warehouse receipts development as a central plank in their development, taking their cue from the development of warehouse warrants on the London Metals Exchange and the Johannesburg Stock Exchange.<sup>19</sup>

#### **D. Collateral management as a tool within structured trade finance**

41. Since the 1990s, collateral management has become an important tool provided by specialist companies and divisions of global inspection firms. Basically, collateral management has two functions: first, through a tripartite collateral management agreement (CMA) between the borrower, the lender and the collateral manager, arrangements are made to ensure that the commodity being used as collateral for security within a trade finance structure is securely and safely stored, to the extent that the goods cannot be damaged, mislaid or mishandled throughout the period of the CMA. The CMA effectively means that the collateral manager gains "constructive possession" of the commodity on behalf of the bank. This constructive possession is essential for the pledge (from the borrower to the lender) of the underlying commodity collateral to be enforceable, so that in the event of a default the bank can take control of the stocks for which loans are being made with a view to realizing the collateral to repay the loan. CMAs have increasingly been used in Africa, Asia and Latin America, although there have recently been some high-profile losses, which have caused collateral management firms to withdraw from certain areas.

42. Many structures, including ownership-based structures, rely on CMAs as part of the collateral control provisions of the structure.

### **IV. Risk management**

43. Risk management is an essential component in any commodity transaction. There are three categories of risk. The first, physical risk, comprises the possible loss or partial

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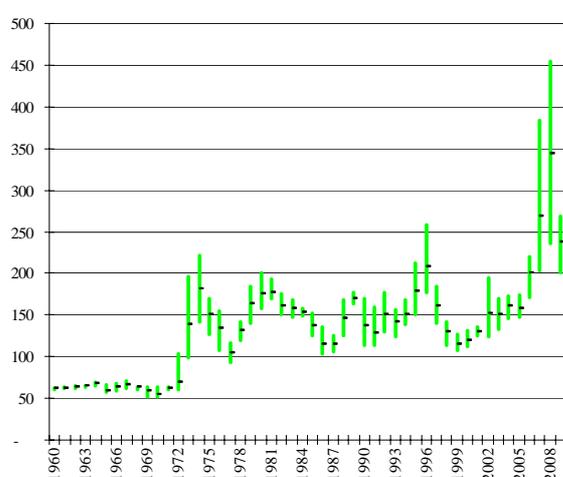
<sup>18</sup> If there is no warehouse receipts law, then warehouse receipts are unlikely to be negotiable instruments. Since 1998, warehouse receipts laws have been introduced, modified or formally proposed in a large number of commodity-dependent developing countries with varying levels of success from an implementation perspective.

<sup>19</sup> Although it is interesting to note that LME warrants and SAFEX warrants traded on the Johannesburg Stock Exchange are accepted and negotiated (traded) as a "custom in practice" and not as part of a system enshrined in national legislation. This is a relic of the English common law system.

loss of the commodity itself arising from theft, damage or deterioration, for example. The second, operational risk, relates to the loss or partial loss arising from mismanagement of the transaction itself, for example where sale and/or purchase contracts are mishandled or if collateral management of the commodity is inadequate (see the section on CMAs above). The third, market-based risk, comprises loss or partial loss from exposure to commodity price volatility. Price risk for producers occurs where the value of the commodity as collateral falls steeply prior to sale. For an intermediary or end-user, price falls affect the value of stored inventory and hence the financial balance sheet will be adversely affected.

44. In all three risk categories identified, as the underlying commodity in purchase and sale transactions is often used as collateral for borrowing purposes, a loss or partial loss poses a significant risk not only for the owner of the commodity (the borrower) but for a bank or financial institution that may have lent using the commodity as security.

**Figure 3. Historical wheat price volatility, 1960–2009**<sup>20</sup>



*Source:* UNCTAD Commodity Price Statistics.

45. Price speculation is an important factor affecting emerging markets producers and consumers alike and it is fuelled by the stockholding of inventories. However, speculators should not necessarily be seen as a deterrent to support trade finance or commodity export-dependent developing countries, or small-scale consumers for that matter. Professional speculators have traditionally provided liquidity to create financial capacity. Often, where speculators are willing, as non-traders, to take positions in commodities, these positions can be part of an asset allocation or price/arbitrage “play” that offers opportunities for physical traders, producers and consumers of commodities to hedge, where otherwise such opportunities might not exist. In fact, since the volume of deliverable commodities is usually a tiny fraction of contracts traded on exchange, speculation by sector traders in a market is a significant driver of liquidity and the success of futures markets.

46. However, price volatility has accelerated hugely in recent years. The graph above (fig. 3) shows how volatility has increased substantially from 2005 onwards, as fundamental traders compete with sector traders (largely speculators and fund/asset managers). There is some evidence that this volatility is the result of heightened speculative

<sup>20</sup> Data series until October 2009 (included).

activity and carry-trade investment strategies, often pursued by investors who see commodities as an asset class to be evaluated alongside any other investment instrument. These investors may be described as “non-participants” in the actual commodity production, trade, export and processing supply chain.<sup>21</sup>

47. In recent years commodities have become financialized in the markets – a phenomenon described in the recent *UNCTAD Trade and Development Report 2009*.<sup>22</sup> This means that where commodities may be seen as an alternative asset class to money, non-participants, i.e. investors (or investment funds), or banks may receive huge returns from inventory stockholding. Essentially, where money can be borrowed at close to zero per cent, financiers seek exposure to commodity inventories where the monthly increase in price of the commodity far outweighs the cost of the financing, warehousing and insuring the same commodity. This seems to be the biggest single financial market factor affecting not only the price of commodities, but their availability, which has substantial ramifications particularly for consumers. This stockholding restricts supply; price volatility ensues, as traders and speculators with short positions seek to cover their trading books at the same time as consumers try to source metal for consumption purposes.

48. To protect the value of collateral being financed (i.e. commodity stocks for which loans have been obtained) price risk protection is a necessity. Mechanisms for price risk protection are provided by commodity exchanges.

#### **A. Commodity exchanges as providers of price risk protection**

49. Traditionally, commodity exchanges provide a physical or an electronic platform so that multiple buyers and sellers trade commodity-linked contracts on the basis of rules and procedures laid down by the exchange. The contracts traded are typically either contracts for spot delivery or risk management instruments such as forward, futures or options contracts. These derivative instruments are traditionally used to manage price risk, i.e. they are used for hedging purposes.

50. In most developing countries commodity exchanges are spot trading exchanges, i.e. where physical trade dominates trade volumes and there is little or no futures trading. There are exceptions in some major emerging economies, such as India. In all cases, commodity exchanges provide a platform to secure the delivery of commodities through a network of registered warehouses. This should provide contractual certainty to buyers and sellers and, in addition, should guarantee that buyers receive goods of a pre-determined quality and quantity.

51. By providing, inter alia, contractual certainty and recognized quality standards, commodity exchanges foster the integration of the development of commodity finance by providing a sense to lenders of the local price of a given commodity, transaction liquidity (trade volumes) and not least, price risk protection for borrowers and lenders.

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<sup>21</sup> See details in UNCTAD (2010). Recent developments in key commodity markets: trends and challenges. TD/B/C.I/MEM.2/7. Geneva. 24–25 March.

<sup>22</sup> UNCTAD (2009). The financialization of commodity markets. In: *Trade and Development Report 2009*. [http://www.unctad.org/en/docs/tdr2009ch2\\_en.pdf](http://www.unctad.org/en/docs/tdr2009ch2_en.pdf)

## **B. Why is price risk protection important from an “access to finance” point of view?**

52. Typically, loans that may be sought using commodity-based collateral depend on the off-take of the commodity at some future point, at which time the price of the commodity and therefore the value of the collateral, is unknown. Within trade finance structures, bankers may require borrowers to show that the price to be received for a given commodity has been “locked in”, i.e. hedged. As part of the commodity loan documentation, proof of price risk management (hedging) is required and evaluated by the potential lender (i.e. the bank.)

## **C. Trading repos – commodity contracts for financial organizations<sup>23</sup>**

53. Farmer repurchase agreements, or “repos” (see fig. 4 below), are an innovative exchange-based product for capital market investors that offer a valuable addition to the existing range of money market instruments. They can benefit a large and relatively organized part of the commodity sector that is looking for relatively cheap sources of capital.

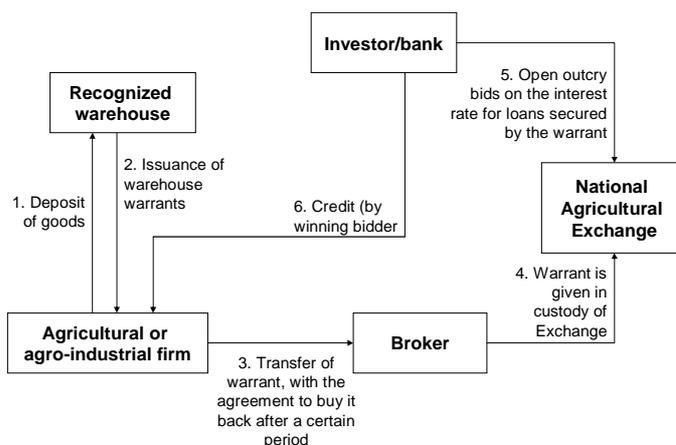
54. For example, Colombia’s National Agricultural and Livestock Exchange (BNA) has developed a whole range of instruments of this nature, with not only agricultural commodities as the underlying collateral, but also poultry and live cattle. In the Bolivarian Republic of Venezuela, a private company, Induservices, developed a system under which it provided capital enhancement to warehouse receipt paper on seasonal maize stocks. This paper was put into a special purpose vehicle, backed by financial securities.

55. The exchange can also structure repos around future receivables rather than existing stocks. For example, Colombia’s BNA introduced an innovative livestock securitization programme in 2000 (and a similar programme for poultry in 2002). The repos have made it possible for cattlemen to obtain tens of millions of United States dollars in financing for the feeding of their cattle – at rates that were determined through competition among institutional investors on the country’s stock and commodity exchanges. Through this mechanism, funds for the feeding of beef cattle were raised from local institutional investors, through livestock-backed securities offered and traded on the BNA and the country’s securities exchanges.

56. Transactions were highly structured to reduce risks for the investors to the minimum. Cattlemen who met certain selection criteria signed contracts with a trust under which they transferred the ownership rights of their cattle to the trust. The trust then sold securities on the basis of these contracts and paid the farmers the funds received. To ensure that farmers properly fed their cattle, an independent company provided extension and quality control services – and was liable to the trust if its services were ineffective. The marketing of the cattle was controlled by an independent marketing agent, who was obliged to transfer the funds received to the trust, which assigned them in priority to the “repurchase” of their cattle by the cattlemen (indeed, most cattle sales were through the BNA auction system).

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<sup>23</sup> This example has been adapted from UNCTAD (2005). *Progress in the Development of African Commodity Exchanges*. UNCTAD/DITC/COM/2005/9.

**Figure 4. Exchange-traded agricultural repos**

57. The value of the collateral much exceeds the value of the securities issued. As a result, the securities have received a high local rating. Several series of securities have been successfully issued on-exchange, with strong interest from both cattlemen and investors with BNA expecting to issue securities worth some \$4–\$5 million every 45 days. The benefits for cattlemen are clear: more financing at better terms, and for institutional investors, the securities provide a new potential investment that may offer an attractive rate at a low risk.

#### **D. Alternative risk mitigation tools: weather index insurance**

58. Risk of drought and other adverse weather conditions is a serious issue affecting agricultural producers in developing countries. Lenders may consider loans to such producers as very risky. One solution is to develop a palette of weather risk insurance products, which can play a critical role in protecting farmers against the worst impact of weather disasters such as drought and floods. As such, weather risk insurance may be a valuable tool for unlocking rural lending and investment opportunities. The role of weather index insurance in facilitating lending could be vital when weather risk is identified as the main impediment to access finance.<sup>24</sup>

59. A weather index typhoon insurance product was piloted in early 2009 by MicroEnsure<sup>25</sup> in the Philippines. The product, relying on satellite-based technology, protects smallholder rice farmers against risks of crop damage. Results from the MicroEnsure pilot show that banks lend 15 per cent to 40 per cent more to farmers who have insurance.<sup>26</sup> With increased access to finance, farmers are able to purchase agricultural inputs such as improved seeds and fertilizers and invest in the agricultural equipment to increase crop yields. They can also diversify into cash crops or non-crop income streams to stimulate the wider rural economy.

<sup>24</sup> Weather index insurance refers to the insurance that is linked with an objectively measurable index such as rainfall rather than the actual loss.

<sup>25</sup> MicroEnsure is an insurance intermediary subsidiary of Opportunity International.

<sup>26</sup> *The Guardian* (2009). India farmers to insure themselves against climate change crop failure. 8 June. <http://www.guardian.co.uk/environment/2009/jun/08/farming-india>

60. There is a growing consensus that weather index insurance could play a positive role in facilitating climate change adaptation. However, for weather index insurance to become more viable, concerted efforts will be needed to improve meteorological data collection systems through technology and investment. Also there will be a need to establish an appropriate legal and regulatory framework for index insurance in the countries where it is to be developed. The global market for these products is still very small and is dominated by the North American market, with high costs restricting their reach particularly in poorer countries and communities. Moreover, the current structure of weather index-based insurance schemes, and their essential pilot status, raises questions as to their likely resilience with respect to large-scale impacts in the face of major catastrophic events, as well as the extent to which they can be relied upon to reduce farmers' insecurity.

## V. Basel II regulation and access to commodity finance

61. Aside from the importance of an enabling legislative framework for commodities trade and finance, there is the matter of financial sector regulation. An important topic for discussion within this context must be the impact of Basel II regulation on trade finance within developing countries on one hand, and on the other, at an international level, whether there is a need to regulate the activities of hedge fund speculators.

62. Basel II replaces the 1988 Basel Capital Accord (Basel I). It is an agreement on a framework for assessing the capital adequacy of banks. The framework sets rules for the allocation of capital to banks' exposures to risks through their lending and other operations. The agreement has two objectives. One is to help ensure the strength and soundness of banking systems. The other is to help equalize cross-border competition between banks by eliminating competitive advantages due to differences among countries in their regimes for capital adequacy.

63. There is a widespread belief that Basel II has had a substantial effect on commodity trade finance and this may have affected commodity-dependent countries significantly. Put simplistically, Basel II rewards highly-rated financial institutions, highly-rated trade firms and highly-rated countries within finance structures by allowing banks to reduce the amount of regulatory risk capital they allocate to the transaction, which in turn affects the cost of the transaction to the bank and equally to the borrower. Furthermore, in commodity finance terms, Basel II largely rewards collateralized transactions over transactions that rely on the creditworthiness of the borrower, unless the borrower has a very high credit rating. Since there are very few highly-rated commodity trade borrowers, the problem is profound for the commodity import and export sector.

64. The adopting of the Basel II Framework is not mandatory, and it is implemented by domestic financial regulators based on the framework issued by the Basel II Committee for Banking Supervision at the Bank for International Settlements.<sup>27</sup> As such, low-income commodity-dependent developing countries, in which there are unlikely to be many highly-rated banks or borrowers, may wish to suggest how some limitations imposed by Basel II could be addressed both at a national policy level and at Basel II Committee for Banking Supervision itself. According to a survey by the International Monetary Fund/Bankers

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<sup>27</sup> Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework. <http://www.bis.org/publ/bcbs107.htm>

Association for Finance and Trade (BAFT),<sup>28</sup> 33 per cent of banks said that Basel II has had a negative effect on their trade financing abilities. The recent major international trade finance initiatives appreciate the importance of further regulatory changes that should normally bring back the simplified access to structured finance by commodity producers and traders.

## VI. Policy challenges and directions

65. Access to commodity finance in commodity-dependent developing countries has decreased since the financial crisis. Although measures have been taken to enhance ECA and DFI financing mechanisms to increase ODA and Aid for Trade and create incentives for increases in South–South finance, there is still a significant shortfall in funding affecting the commodity sector at large. This is particularly affecting developing countries, and those which are commodity-dependent are the worst hit, since commodity booms and busts have major effects on their current account position. Problems are exacerbated by the quantum of the liquidity crisis itself, and the relative inability of ECAs, DFIs and other funding agencies to fill the financing gap, largely because of capacity constraints.

66. In turn, commodity producers and exporters in commodity-dependent developing countries have suffered from market volatility arising from the commodity boom-and-bust cycle, with detrimental consequences for their investment planning. Therefore, providing stability in commodity markets together with sustainable development is not only of critical importance to producers and exporters in those countries, but also to the economic health and survival of the country itself. Not only are new and increased sources of funding required, but new financing mechanisms need to be found to address the financial requirements of local, and particularly small-scale, players in the commodity sector of low-income commodity-dependent developing countries.

67. At the policy level, access to commodity finance is contingent on a number of factors. Policies need to be designed to enhance the attractiveness of investment in commodity infrastructure-related projects. It is important to identify ways to increase sources and access to finance by small-scale producers in commodity-dependent developing countries. This could be achieved by encouraging the development of new sources of commodity finance and augmenting existing sources, and developing financial mechanisms to enhance commodity trade and mitigate risk and/or loss in trade finance structures. However, there are no simple answers to these issues, given the characteristics of international commodity markets. Hence many factors will need to be carefully examined if these objectives are to be reached.

68. In this respect the intergovernmental experts may wish to seek answers to the questions below.

### A. Questions regarding sources of finance

(a) Is it possible to further expand or develop initiatives such as the IFC Global Trade Liquidity Programme, and the Asian Development Bank, OFID trade finance and facilitation programmes?

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<sup>28</sup> IMF-BAFT (2009). *Trade Finance Survey among Banks Assessing the Current Trade Finance Environment*.

(b) What are the mechanisms available for the promotion of South–South financing and under what conditions could these thrive?

(c) Are there means by which ECAs can be encouraged to further engage in direct lending to producers and exporters in commodity-dependent developing countries?

(d) What can be done to close the gap between actual ODA financial inflows and the levels of aid that may be required to meet the Millennium Development Goals?

## **B. Questions regarding financing instruments and mechanisms**

(a) How can new projects be developed to encourage a supply chain financing approach in the poorest commodity-dependent countries?

(b) Which trade finance structures are most relevant in the context of delivering finance to small-scale producers and exporters, rather than larger scale intermediaries and offshore trade participants?

(c) How is it possible to reduce price speculation and volatility without compromising on the optimal level of liquidity needed for the successful functioning of commodity futures markets, while also making sure that enough finance is available for commodity supply chain finance?

(d) Is there a continuing role for so-called “non-participants” in the commodities market? If so, how can any potential adverse impacts arising from their activities be addressed?

(e) Which risk mitigation tools are most relevant for low-income commodity-dependent developing countries?

(f) Does Basel II offer a competitive regulatory framework for developing countries? How could the provisions and requirements of Basel II and other regulatory interventions facilitate access to commodity trade finance?

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